

# **Solutions manual**

to accompany

## **Accounting**

**10<sup>th</sup> edition**

by

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# **WILEY**

## Chapter 2: Financial statements for decision making

### Questions and solutions which have a GSTversion:

- Exercise 2.11
- Problem 2.23
- Problem 2.25
- Problem 2.27

### Discussion questions

- 1. Explain the basic differences between a sole trader (or single proprietorship), a partnership and a company. Discuss the factors that need to be considered in selecting an appropriate structure for Cynthia's Beauty Services business.**

The three basic business structures are:

- Sole traders are where individuals conduct business in their own capacity. They would be contributing their own capital or equity to the business and would be borrowing money in the name of the business in their own name. They would be liable to repay the outstanding debt of the business and, if unable to repay, the bank, would have access to their own personal assets to repay the outstanding debt. This business structure is suitable for small operations with small staff and turnover. The sole trader has sole responsibility and control for the business operations and activities. This structure is suitable for small businesses which require minimal capital to set up and have relatively low running costs and risk.
- A partnership is two or more persons in business together, operating under a partnership agreement which may or may not be a formally written document. Partnerships have the advantage over sole traders in that they have a larger base for capital contribution and are able to share the risks and responsibilities associated with running a business. The partnership is treated as a separate entity for accounting purposes but is not a separate legal entity. This means that the underlying assets and liabilities of a partnership belong to the individual partners in the proportion agreed upon as part of the partnership agreement. Therefore if the business activities prove to be unsuccessful, creditors have the right to access the personal assets of the individual partners in the event the business is unable to repay any outstanding debt. For this reason, the partnership structure is usually used where there is a low element of risk to the business or where the law dictates that the business entity must be run by the individuals providing the service. For example, work completed by professionals including accountants and lawyers.
- The company is a separate legal entity with ownership of a company attributed to shares held. The owners of the company are known as shareholders. The advantage of this business structure is that, as a separate legal entity, the assets and liabilities belong to the company. In the event the business is unable to repay its debt, the creditors only have access to company assets for repayment of the debt. The investment in the company by its shareholders is limited only to the shareholders' capital contribution, i.e. what the shareholder pays for the shares. This business structure is more appropriate for entities requiring larger capital contribution, which have a large number of overheads and employees and has a higher business risk. The disadvantages include higher set up and ongoing costs

and possible reduction in control over the business operations where shareholders are not directly involved in the business operations.

Factors that Cynthia needs to consider in selecting an appropriate structure for her business include:

- Simplicity in setting up the business: sole traders and small partnerships are easier to set up compared to companies.
- Establishment costs: companies are more expensive to establish compared to sole traders and partnerships.
- Liability issues: sole traders and partnerships have unlimited liability, which means owners and partners are personally liable for their business' debts, including those resulting from lawsuits or the actions of other partners. If unlimited liability is a concern, then Cynthia may want to consider setting up a company instead of being a sole trader or partnership.
- Tax: tax reporting requirements for companies are far greater than for sole traders and partnerships.
- Control of the business: as an owner of a sole trader, Cynthia would have a complete control over her business. If she chooses to partner with someone through a partnership, she will need to discuss business matters with her partner. If Cynthia decides to set up a company and employs a management team, she may not have as much control in running the business as it will be the responsibility of the management team.
- Access to capital: the access to finance for a sole trader is limited to the owner's resources. On the other hand, a partnership has greater access to capital from resources of all partners, and a company has even far greater access to capital from various shareholders.

## **2. Oxfam is a 'not-for-profit' entity. Discuss what it means to be a 'not-for-profit' entity.**

The Australian accounting standards define a not-for-profit entity as 'an entity whose principal objective is not the generation of profit' (AASB 136 para. Aus6.2). This means that a not-for-profit entity can still generate profits, however any profit generated by the entity must be used to further the entity's objectives rather than serve the interests of the members or owners. For example, Oxfam is a not-for-profit entity as any surplus or profit made from its operations will be used to achieve its purpose, which is to create lasting solutions in order to free people from poverty.

For tax purpose, not-for-profit entities in Australia can be categorised as charities (such as Oxfam), income tax exempt funds, and other not-for-profit organisations (such as sporting clubs and community service groups). Performance of not-for-profit entities can be assessed by comparing their activities to their stated goals for the period.

**3. Entities are expected to perform in the spheres of profit, people and the planet. List some key performance indicators applicable to each sphere.**

The sphere of profit relates to financial performance and business strategies of the entities. Examples of key performance indicators under the profit sphere include:

- profit margin
- profit after tax
- return on assets
- return on equity
- asset turnover
- EPS growth
- sales growth.

The sphere of people relates to the entities' employees and involvement in the community. Examples of key performance indicators under the people sphere include:

- employee turnover rate
- employee absenteeism
- number of work place accidents
- percentage of female employees
- donations to charities
- programs run by the entities for the community.

The sphere of planet relates to the impact of the entities' operations on the environment. Examples of key performance indicators the planetsphere includes:

- carbon gas emissions
- water and electricity usage
- recycling program
- waste management.

- 4. The coach of the local football team was trying to motivate the team before a big match. He said: ‘Our team is like any organisation. We must have goals, we must practise the usual management functions, and we must make use of all relevant information’. Explain if you agree with the coach? If not, explain your position.**

The management of a sporting team must have goals, e.g. winning, putting up a good performance, reputation, character-building of team members and recruitment of new members.

The management of a sporting team must plan, organise, direct, and control the team’s efforts and generally operate like any other business organisation.

In order to plan team performance, the coach would need some relevant available information to plan performance, develop a game plan, direct play during the match, and gather information so that an analysis of the game may lead to improved future performance.

Some discussion could take place on how a team would operate without such management principles being used.

- 5. Analyse why the cash received from the sale of a good is income yet the cash contributed by the owner is not income.**

The *Conceptual Framework* defines income as ‘increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants’ (para. 70(a)). In other words, for an item to be classified as income, there must be increases in economic benefits which result in increases in equity, and the increases in economic benefits must not come from owners. Both cash from sale of a good and cash contributed by owner are increases in economic benefits which increase equity. However, cash contributed by the owner is not income as it is a form of contributions from equity participants (i.e. the owner), whereas cash from sale of a good is income as it does not come from the owner but from customers.

**6. Discuss whether an asset needs to be legally owned to be recorded as an asset on the balance sheet.**

Assets are defined in the *Conceptual Framework* as ‘resources controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity’ (para. 49(a)). That is, to be recorded as assets, the entity must have the ability to benefit from the use of the assets and deny access of others to the benefits (i.e. control).

Although, in most cases, legal ownership will give the entity control over an asset, certain types of lease arrangements can result in the entity controlling the asset. For example, finance leases transfer the risks and benefits of ownership to the lessee, which means the leased asset is now controlled by the lessee. Subsequently, the leased asset should be recorded as an asset on the lessee’s balance sheet, even though the lessee does not legally own the asset just yet.

Furthermore, following the qualitative characteristics of faithful representation in the *Conceptual Framework*, it is important that the economic substance rather than the legal form of the transaction is reported. In a finance lease, legal title to the leased asset still remains with the lessor until the end of the relevant lease term when the lessee has made all lease payments. However, the lessee has use of and earns economic benefits from the leased asset for this time period (i.e. economic substance), and hence the leased asset should be recorded as an asset in the lessee’s balance sheet during the period of the lease term.

In summary, an asset does not need to be legally owned by the entity to be recorded as an asset on the balance sheet. As long as the entity controls the asset, then the asset must be reported on the entity’s balance sheet.

**7. A local football club has won the premiership for the past four years. Accordingly, the club has a very strong supporter base. Rationalise if the players would be regarded as an asset of the business to be recognised on the balance sheet.**

To be recognised as an asset on the balance sheet, an item must satisfy definition and recognition criteria specified in the *Conceptual Framework*. An asset is defined in the Framework as a resource controlled by the entity as a result of past events and from which future economic benefits will flow to the entity. The three definition criteria must be satisfied if the players were to be recognised on the balance sheet as assets to the football club:

- **Future economic benefits:** the players do provide future economic benefits to the football club through the use of their skills. The benefits could be in the form of ticket sales to see the players, winning the premiership, strong supporter base, product's endorsements, sponsorships, etc.
- **Control:** control is the ability to benefit from the use of the assets and deny access of others to the benefits. It could be argued that the football club does not have sufficient control over its players. Although the players might have signed a contract with the club, they can still leave the club and play somewhere else. The club does not own its players and the players' skills that are used to generate future economic benefits ultimately belong to the players, not the club.
- **Past events:** these are past transactions that give rise to control. Since the football club does not have control over its players, there is no past transaction that gives rise to control. Signing a contract or giving a lump sum amount as 'advance payment' does not give the club control over the players.

In addition to the definition criteria, two recognition criteria must also be satisfied for an asset to be recorded on the balance sheet:

- **Probable occurrence:** this means that the future economic benefits are more like (than less likely) to flow into the football club. It can be argued that future economic benefits as mentioned above are likely to flow to the club as a result of players using their skills.
- **Reliable measurement:** to be recognised on the balance sheet, the players must have value that can be measured with reliability. In this case, there is no reliable system that can be applied to measure how much players are worth. Each player is unique, and hence it is very difficult to assign an objective value to each player.

To be recorded on the financial statements, all criteria must be satisfied. From the explanation above, it can be seen that players do not satisfy the definition and recognition criteria of assets. Subsequently, they cannot be recorded as assets on the balance sheet. It should be noted that it is not necessary to work through the recognition criteria if it is determined that the item does not satisfy the definition criteria. All aspects of the definition and recognition criteria must be satisfied for the item to be recognised on the balance sheet.

**8. As the accountant at a local council, explain to the Chief Executive Officer if the land under roads is an asset that should be recorded on the Council's balance sheet.**

AASB 1051 *Land Under Roads* prescribes that an entity may elect to recognise (subject to the satisfaction of asset recognition criteria) or not to recognise as an asset land under roads acquired before the end of the first reporting period ending on or after 31 December 2007. The final decision of whether to recognise or not shall be made effective as at the first day of the next reporting period following the end of the first reporting period ending on or after 31 December 2007.

Assuming the Council has a reporting period ending 30 June, AASB 1051 mandates that the Council is required to choose whether it would recognise (or not) land under roads acquired on or before 30 June 2008. Land acquired after 30 June 2008 is to be treated as an asset of the Council in accordance with the AASB 116 *Property Plant & Equipment*.

**9. Moonshine Enterprises hired an accountant at the rate of \$1000 per week. The person is to commence duty on 1 February. Explain if the business has a liability in respect of the accountant's salary as at 1 February.**

Suggested topics for discussion re Moonshine Enterprises:

- On 1 February, the business does not have a liability because, at this stage, they are not presently obliged to sacrifice future economic benefits (his/her wage paid in **cash**), i.e. not until the expense has occurred, which isn't recognised until it is probable that the consumption has occurred and can be measured reliably.
- The contract remains unperformed by both parties until the work is completed by the employee.

**10. Discuss the significance of the following assumptions in the preparation of an entity's financial statements:**

- (a) Entity assumption**
- (b) Accrual basis assumption**
- (c) Going concern assumption**
- (d) Period assumption**

(a) Entity assumption:

If the transactions of an entity are to be recorded, classified and summarised into financial statements, the accountant must be able to identify clearly the boundaries of the entity being accounted for. Under the accounting entity assumption, the entity is considered a separate entity distinguishable from its owner and from all other entities. It is assumed that each entity controls its assets and incurs its liabilities. The records of assets, liabilities and business activities of the entity are kept completely separate from those of the owner of the entity as well as from those of other entities.

The accounting entity assumption is important since it leads to the derivation of the accounting equation.

(b) The accrual basis assumption:

Under the accrual basis of accounting, the effects of transactions and events are recognised in accounting records when they occur, and not when the cash is received or paid. Hence, financial statements report not only on cash transactions but also on obligations to pay cash in the future and on resources that represent receivables of cash in future. It is argued in the *Conceptual Framework* that accounting on an accrual basis provides significantly better information about the transactions and other events for the purpose of decision making by users of financial statements than does the cash basis.

(c) The going concern assumption:

According to the *Conceptual Framework*, financial statements are prepared on the assumption that the existing entity is expected to continue operating into the future. It is assumed that the assets of the entity will not be sold off and that the entity will continue its activities; hence, liquidation values (prices in a forced sale) of the entity's assets are not generally reported in financial statements, as this assumes that an entity is to be wound up.

When management plans the sale or liquidation of the entity, the going concern assumption is then set aside and the financial statements are prepared on the basis of estimated sales or liquidation values. The significance of the going concern assumption is in the valuation placed on the assets of an entity in the entity's financial statements. The statements should identify clearly the basis upon which asset values are determined — going concern? Or liquidation?

(d) The period assumption:

For financial reporting purposes, it is assumed that the total life of an entity can be divided into equal time intervals. Hence, the financial performance of the entity can be determined for a given time period, and the financial position of the entity can be determined on the last day of that reporting period.

As a result of this assumption, profit determination involves a process of recognising the income for a period and deducting the expenses incurred for that same period. Together, the period assumption and accrual basis assumption lead to the requirement for making end-of-period adjustments on the last day of the reporting period. These adjustments will be considered in chapter 4.

### 11. List and define the fundamental and enhancing characteristics of financial information.

The two fundamental characteristics of financial information are:

- **Relevance:** relevance means that the information contained in financial statements is able to influence the economic decisions made by users. For example, the information may help users to predict future events, such as future cash flows, from alternative courses of action under consideration. Also, information is relevant if it is able to help decision makers evaluate past decisions. The information may confirm that a previous decision was correct, or it could show that the results of a previous decision were undesirable and that a new decision is necessary. Thus, relevant information is said to play a predictive role and a confirmatory or feedback role.
- **Faithful representation:** faithful representation is attained when the depiction of an economic event is complete (i.e. all information necessary to represent the event are included), neutral (i.e. free from bias), and accurate (i.e. free from material error). In addition, financial information that faithfully represents an economic phenomenon should depict the economic substance of the underlying transaction, event or circumstances, rather than its legal form.

The four enhancing characteristics of financial information are:

- **Comparability:** comparability is the quality of information that enables users to identify similarities in and differences between two sets of economic data. For financial information to be comparable, users need to be able to compare information of an entity over time, and between entities at one time and over time.
- **Verifiability:** if financial information is verifiable, it means that different independent observers would reach general agreement that the information represents economic event it purports to represent without material error or bias.
- **Timeliness:** to be relevant for decision-making, financial information must be available in a timely manner. If there is undue delay in reporting the information to users, then the information will lose its capacity to influence decisions (i.e. no longer relevant).
- **Understandability:** the Conceptual Framework defines understandability as the quality of information that enables users who have a reasonable knowledge of business and economic activities and financial accounting, and who study the information with reasonable diligence, to comprehend its meaning.

**12. Distinguish between the concepts of consistency and comparability and discuss if the same accounting method should always be applied consistently in financial statements.**

The IASB Exposure Draft, *An Improved Conceptual Framework for Financial Reporting: Chapter 2: Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information*, issued in May 2008, describes comparability as an enhancing characteristic of information i.e. it enhances the usefulness of financial reporting information in making economic decisions. Comparability is the quality of information that enables users to identify similarities in and differences between two sets of economic data. Consistency refers to use of the same accounting policies and procedures, either from period to period within an entity or in a single period across entities. The Exposure Draft argues that comparability is the goal, and that consistency of policies and procedures is a means to an end that helps to achieve the goal. However, it is not satisfactory for policies and procedures to be applied consistently if the information that they produce is no longer relevant or a faithful representation of economic reality.

**13. Your doctor knows that you are studying accounting. He has recently received the annual report for a company in which he is a shareholder. The financial report within the annual report is lengthy and your doctor requests your advice as to whether he should contact the company to complain that the financial information is not understandable. Advise your doctor.**

According to the *Conceptual Framework*, understandability is the quality of information which enables users who have a reasonable knowledge of business and economic activities and financial accounting, and who study the information with reasonable diligence, to comprehend its meaning. It should be clear that, even though it is desirable for financial statements to be expressed in simple language, relevant information should not be excluded merely because it may be too complex or difficult for some untrained users to understand.

Understandability does not mean simplicity. If users cannot understand the information contained in financial statements, they should seek the help of a trained adviser. Therefore, it is advised that the doctor should not contact the company to complain that the financial report is not understandable. Instead, he should seek help from his accountant or financial planner to help him understanding the information in the financial report.

**14. Management expert Professor Henry Mintzberg has argued that a manager's work can be characterised by ten common roles falling into three categories: informational (managing by information), interpersonal (managing through people), and decisional (managing through action). Provide an example of activity in each of these three categories.**

The informational category (managing by information) involves managers' roles in **processing** information. Examples of activities under the informational category include:

- Seeking out information related to the organisation and industry, and looking for relevant changes in the environment in which the organisation operates.
- Monitoring employees in terms of their productivity and well-being.
- Communicating potentially useful information to colleagues and employees.
- Transmitting information about the organisation to people outside the organisation (i.e. being a spokesperson).

The interpersonal category (managing through people) involves managers' roles in **providing** information and ideas. Examples of activities under the interpersonal category include:

- Providing leadership to the team or organisation.
- Managing performance and responsibilities of employees within the organisation.
- Providing inspiration to subordinates and being a figurehead.
- Building effective networking with people inside and outside the organisation.

The decisional category (managing through action) involves managers' roles in **using** information. Examples of activities under the decisional category include:

- Generating new ideas and implementing them.
- Solving problems and mediating disputes.
- Allocating resources.
- Taking part in negotiations.

**15. 'Faithful representation' is a fundamental characteristic of financial information. This term replaced 'reliable' in the 2010 revisions to the *Conceptual Framework*. Discuss the rationale for this change.**

In the IASB Exposure Draft *An Improved Conceptual Framework for Financial Reporting: Chapter 2: Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information* issued in May 2008, the IASB observed that there are a variety of views of what reliability means. For example, some focus on verifiability or free from material error to the virtual exclusion of the faithful representation aspect of reliability. On the contrary, to others reliability apparently refers primarily to precision. Because the meaning of reliability was not clear to constituents, the IASB proposed that it should be replaced by the concept of faithful representation. Accordingly, faithful representation encompasses all of the qualities that the previous frameworks included as aspects of reliability. Faithful representation is the depiction in financial reports of the economic phenomena they purport to represent.

## Exercises

### Exercise 2.1

#### Preparing a balance sheet

Financial items for George Karatsis IT Services on 31 May 2019 are presented below in alphabetical order.

|                     |           |                  |           |
|---------------------|-----------|------------------|-----------|
| Accounts payable    | \$ 64 000 | Land             | \$250 000 |
| Accounts receivable | 70 000    | Mortgage payable | 710 000   |
| Building            | 520 000   | Office equipment | 180 000   |
| Cash at bank        | 61 000    | Office supplies  | 34 000    |

#### Required

- (a) Prepare a balance sheet similar to the one in figure 2.2. (Note: a major item is missing in the list.)  
 (b) Reformat the statement to present it in narrative form as in figure 2.3.  
 (LO4)

(a)

| <b>GEORGE KARATSIS IT SERVICES</b> |                    |                          |                    |
|------------------------------------|--------------------|--------------------------|--------------------|
| <b>Balance Sheet</b>               |                    |                          |                    |
| <b>as at 31 May 2019</b>           |                    |                          |                    |
| <b>ASSETS</b>                      |                    | <b>LIABILITIES</b>       |                    |
| Cash at bank                       | \$61 000           | Accounts payable         | \$64 000           |
| Accounts receivable                | 70 000             | Mortgage payable         | 710 000            |
| Office supplies                    | 34 000             |                          | 774 000            |
| Office equipment                   | 180 000            |                          |                    |
| Land                               | 250 000            | <b>EQUITY</b>            |                    |
| Building                           | 520 000            | George Karatsis, Capital | 341 000            |
|                                    | <b>\$1 115 000</b> |                          | <b>\$1 115 000</b> |

(b)

| <b>GEORGE KARATSIKIS IT SERVICES</b> |                    |
|--------------------------------------|--------------------|
| <b>Balance Sheet</b>                 |                    |
| <b>as at 31 May 2019</b>             |                    |
| <b>ASSETS</b>                        |                    |
| Cash at bank                         | \$61 000           |
| Accounts receivable                  | 70 000             |
| Office supplies                      | 34 000             |
| Office equipment                     | 180 000            |
| Land                                 | 250 000            |
| Building                             | 520 000            |
| <b>TOTAL ASSETS</b>                  | <b>\$1 115 000</b> |
| <b>LIABILITIES</b>                   |                    |
| Accounts payable                     | \$64 000           |
| Mortgage payable                     | 710 000            |
| <b>TOTAL LIABILITIES</b>             | <b>774 000</b>     |
| <b>NET ASSETS</b>                    | <b>\$341 000</b>   |
| <b>EQUITY</b>                        |                    |
| George Karatsis, Capital             | \$341 000          |
| <b>TOTAL EQUITY</b>                  | <b>\$341 000</b>   |

**Exercise 2.2**

**Income statement and analysis**

During the year ended 30 June 2019, Skilled Services, a provider of temporary secretary personnel, had collected receipts from clients for a total value of \$250 000. Wages of \$136 000 had been paid to the temporary workers, rental of office space and electricity costs were \$12 000 and \$13 700 respectively for the year, and the owners withdrew \$20 000 for their personal use.

**Required**

- (a) Prepare an income statement for the year for Skilled Services.
  - (b) Skilled Services is a sole proprietor. Compare the liability of a sole proprietor with that of a company shareholder.
- (LO1, LO3 and LO5)

(a)

| <b>SKILLED SERVICES</b>                |           |           |
|--|-----------|-----------|
| <b>Income Statement</b>                |           |           |
| <b>for the year ended 30 June 2019</b> |           |           |
| <b>INCOME</b>                          |           |           |
| Services income                        |           | \$250 000 |
| <b>EXPENSES</b>                        |           |           |
| Wages                                  | \$136 000 |           |
|  | 0         |           |
| Office Rental                          | 12 000    |           |
| Electricity Costs                      | 13 700    |           |
|  | 161 700   |           |
| <b>PROFIT</b>                          |           | \$88 300  |

(b) The concept of limited liability means that shareholders are not personally liable for the debts of the company in the event of the company’s liquidation. In other words, the liability of shareholders to contribute to the assets of the company is limited to the amount unpaid on the shares held in the company. This is contrary to sole traders and partnerships in which creditors are able to take away the owners/partners’ personal assets to settle for the business’ debts if the business is liquidated.

### Exercise 2.3

#### Analysis of equity

Sarah Hodge is a self-employed piano teacher operating her business from home. She keeps her accounting records for business activities completely separate from her records for personal activities. At 30 June 2018, Sarah had business assets and liabilities worth \$62 500 and \$41 000 respectively. At 30 June 2019, Sarah had business assets and liabilities worth \$56 000 and \$38 000 respectively.

#### Required

- (a) Assuming Sarah did not contribute to or withdraw from the business during the financial year, determine the profit/loss for the year.
- (b) Assuming Sarah had withdrawn \$15 000 during the year, determine the profit/loss for the year.
- (c) Assuming Sarah had contributed \$20 000 and withdrawn \$12 000, prepare a statement of changes in equity for the year.

(LO5)

Calculation of Equity as at 30 June 2018 is \$21 500  
(i.e. \$62 500 – \$41 000)

Calculation of Equity as at 30 June 2019 is \$18 000  
(i.e. \$56 000 – \$38 000)

- (a) Capital Contributions and Drawings are nil for the year.

Ending Equity \$18 000 – Beginning Equity \$21 500  
= **Loss of \$3500**

- (b) Capital Contributions nil and drawings \$15 000 for the year.

Ending Equity \$18 000 – Beginning Equity \$21 500 – Drawings \$15 000  
= **Profit \$11 500**

(c)

| <b>SARAH HODGE – PIANO TEACHER</b>     |                      |
|--|----------------------|
| <b>Statement of Changes in Equity</b>  |                      |
| <b>for the year ended 30 June 2019</b> |                      |
| Sarah Hodge, Capital – 1 July 2018     | \$21 500             |
| Add: Capital contribution for the year | 20 000               |
| Less: Loss for the year*               | (11 500)             |
|  | <hr/>                |
|  | 30 000               |
| Less: Drawings during the year         | 12 000               |
|  | <hr/>                |
| Sarah Hodge, Capital – 30 June 2019    | <hr/> <hr/> \$18 000 |

\* Loss is the balancing item.

**Exercise 2.4****Determining profit from equity balances**

Equity balances for Sen Widayaya appearing in the balance sheets of Widayaya's Window Washing Services as at 30 June 2019, 2018 and 2017 are set out below.

|                       | 30 June 2019 | 30 June 2018 | 30 June 2017 |
|-----------------------|--------------|--------------|--------------|
| <b>EQUITY</b>         |              |              |              |
| Sen Widayaya, Capital | \$27 300     | \$30 000     | \$28 000     |

During 2017–18, Sen withdrew \$25 000 for personal use and also contributed additional capital of \$8000. During 2018–19, he withdrew \$10 000 capital from the business, and withdrew \$15 000 cash for his own use in anticipation of profits.

**Required**

- (a) Determine the profit/loss earned by the business in each of the 2 years ended 30 June 2019 and 30 June 2018.

(a)

| <b>WIDYAYA'S WINDOW WASHING SERVICES</b> |               |               |
|--|---------------|---------------|
| <b>Profit for years ended 30 June</b>    | <b>2018</b>   | <b>2019</b>   |
| Beginning Capital                        | \$28 000      | \$30 000      |
| + Additional Capital Contributions       | 8 000         | —             |
| – Withdrawals of Capital                 | —             | (10 000)      |
| – Drawings                               | (25 000)      | (15 000)      |
| <b>Profit</b>                            | <b>19 000</b> | <b>22 300</b> |
| Ending Capital                           | \$30 000      | \$27 300      |

## **Exercise 2.5**

### **Operating, investing and financing activities**

**Classify each of the following activities as being operating, investing or financing for the purpose of preparing a statement of cash flows. Indicate whether there is an inflow (I) or outflow (O) of cash.**

- (a) sale of land and buildings for cash**
  - (b) payment of wages to employees**
  - (c) withdrawal of cash by the owner**
  - (d) repayment of a bank loan**
  - (e) cash purchase of a truck by a manufacturing company**
  - (f) lease of a fleet of motor vehicles by a courier business**
  - (g) borrowing of money from a finance company on a long-term basis**
  - (h) cash received from customers for the sale of goods**
- (LO5)**

- |              |     |
|--------------|-----|
| (a)Investing | [I] |
| (b)Operating | [O] |
| (c)Financing | [O] |
| (d)Financing | [O] |
| (e)Investing | [O] |
| (f)Investing | [O] |
| (g)Financing | [I] |
| (h)Operating | [I] |

## Exercise 2.6

### Elements in financial statements

A friend who has established a new dance studio, Hip and Hop, has asked you to give some advice as to the contents of financial statements. Transactions of Hip Hop include:

- (a) contribution of cash by your friend to the business
- (b) purchase of studio sound equipment on credit
- (c) electricity costs paid
- (d) studio fees received in cash
- (e) the owner's house
- (f) rental of a chilled water machine, paid in cash
- (g) money withdrawn by your friend to pay university fees for a friend
- (h) cash held by the business at the end of the year
- (i) money borrowed for purchase of building.

### Required

Indicate whether these items would appear in Hip and Hop's balance sheet, income statement, statement of changes in equity and/or statement of cash flows. For those items included in the statement of cash flows, indicate whether the item relates to operating activities, investing activities, or financing activities. [*Hint:* Some items may appear in more than one financial statement.] (LO3 and LO5)

- (a) Balance sheet, statement of changes in equity, and statement of cash flows (Financing — treated as a contribution of capital)
- (b) Balance sheet only
- (c) Income statement and statement of cash flows (Operating)
- (d) Income statement and statement of cash flows (Operating)
- (e) Not reported in the financial statements as not part of the accounting entity 'Hip and Hop'
- (f) Income statement and statement of cash flows (Operating)
- (g) Balance sheet (reduction of capital), statement of cash flows (Financing as part of owner's drawings of capital from the business), statement of changes in equity
- (h) Balance sheet and statement of cash flows (cash or cash equivalent balance).
- (i) Balance sheet and statement of cash flows (Financing — for loan amount), (Investing — for purchase of building)

## **Exercise 2.7**

### **Assumptions and characteristics of information**

**Identify by letter the assumption or characteristic of information which best represents the situations given.**

**A. Accounting entity assumption**

**B. Accrual basis assumption**

**C. Going concern assumption**

**D. Period assumption**

**E. Relevance**

**F. Faithful representation**

**G. Materiality**

**H. Comparability**

**(LO3)**

- F. 1. The reporting of accounting information should be free from personal bias.
- A. 2. In a single proprietorship, the owner's house and car are not recorded in the records of the business.
- G. 3. The cost of stationery is not shown separately in the income statement.
- B. 4. Services provided by a business entity are recorded before the receipt of cash.
- E. 5. Machinery held by the business under a long-term lease arrangement is recorded by the business as its own asset.
- D. 6. An expense is recorded in the year in which an asset or benefit is consumed in the process of carrying on the entity's business.
- C. 7. Assets are not recorded at liquidation prices.
- H. 8. Consistent accounting policies and methods are used in the preparation of financial statements from one year to another.

## Exercise 2.8

### Business transactions

For each of the following, describe a transaction that would have the stated effect on the accounting equation:

- (a) **Increase an asset and increase a liability**
- (b) **Decrease one asset and increase another asset**
- (c) **Decrease an asset and decrease equity**
- (d) **Increase an asset and increase equity**
- (e) **Decrease a liability and decrease an asset**
- (f) **Decrease an equity item and decrease an asset.**

**(LO5)**

- (a) Purchase an asset on credit.
- (b) Purchase an asset for cash.
- (c) Owner withdraws cash from the business for personal use.
- (d) Owner contributes cash to the business.
- (e) The business pays cash to its creditors.
- (f) The owners withdraw cash.

Students may have many other possible examples in each of (a)–(f).

## Exercise 2.9

### Preparation of a balance sheet

Month-end balance sheet amounts for the legal practice of Adam Booth, a local lawyer, for 3 consecutive months of 2019 are shown below. The information is complete except for the balance in the Capital account.

|                     | October  | November | December |
|---------------------|----------|----------|----------|
| Cash at bank        | \$ 9 100 | \$ 3 900 | \$ 3 000 |
| Accounts receivable | 16 100   | 15 000   | 8 050    |
| Prepaid insurance   | 700      | 1 800    | 1 600    |
| Office equipment    | 29 800   | 29 700   | 39 300   |
| Property            | 226 000  | 224 000  | 222 000  |
| Accounts payable    | 10 100   | 3 100    | 3 000    |
| Wages payable       | 5 100    | 4 100    | 4 800    |
| Mortgage payable    | 134 700  | 134 300  | 133 900  |
| Adam Booth, Capital | ?        | ?        | ?        |

### Required

- Determine the balance in Adam Booth's Capital account at the end of each month.
  - Assuming that Booth made no additional investments and did not withdraw any money from the business during the 3 months, determine the profit for November and for December.
  - Prepare a balance sheet for the business at the end of December 2019. (The heading should read: Adam Booth, Lawyer.)
- (LO3 and LO5)

(a)

Based on the accounting equation: Assets – Liabilities = Equity

$$\begin{aligned}
 \text{31 October Capital Balance} &= (\$9100 + 16\,100 + 700 + 29\,800 + 226\,000) \\
 &\quad - (\$10\,100 + 5100 + 134\,700) \\
 &= \mathbf{\$131\,800}
 \end{aligned}$$

$$\begin{aligned}
 \text{30 November Capital} &= (\$3900 + 15\,000 + 1800 + 29\,700 + \\
 \text{Balance} &\quad 224\,000) - (\$3100 + 4100 + 134\,300) \\
 &= \mathbf{\$132\,900}
 \end{aligned}$$

$$\begin{aligned}
 \text{31 December Capital} &= (\$3000 + 8050 + 1600 + 39\,300 + 222\,000) \\
 \text{Balance} &\quad - (\$3000 + 4800 + 133\,900) \\
 &= \mathbf{\$132\,250}
 \end{aligned}$$

(b)

Profit for November = \$132 900 – \$131 800  
= **\$1100**

Loss for December = \$132 250 – \$132 900  
= **-\$650**

(c)

| <b>ADAM BOOTH, LAWYER</b>     |                  |
|-------------------------------|------------------|
| <b>Balance Sheet</b>          |                  |
| <b>as at 31 December 2019</b> |                  |
| <b>ASSETS</b>                 |                  |
| Cash at bank                  | \$3 000          |
| Accounts receivable           | 8 050            |
| Prepaid insurance             | 1 600            |
| Office equipment              | 39 300           |
| Property                      | 222 000          |
| <b>TOTAL ASSETS</b>           | <b>\$273 950</b> |
| <b>LIABILITIES</b>            |                  |
| Accounts payable              | \$3 000          |
| Wages payable                 | 4 800            |
| Mortgage payable              | 133 900          |
| <b>TOTAL LIABILITIES</b>      | <b>141 700</b>   |
| <b>NET ASSETS</b>             | <b>\$132 250</b> |
| <b>EQUITY</b>                 |                  |
| Adam Booth, Capital           | \$132 250        |
| <b>TOTAL EQUITY</b>           | <b>\$132 250</b> |

## Exercise 2.10

### Explaining accounting transactions

The following schedule shows the effect of several transactions on the accounting equation of Preya Palit and the balance of each item in the equation after each transaction. Write a sentence to explain the nature of each transaction. (LO5)

|     | Assets       |   |                     |   |                  | =      | Liabilities     | + | Equity           |   |                      |
|-----|--------------|---|---------------------|---|------------------|--------|-----------------|---|------------------|---|----------------------|
|     | Cash at Bank | + | Accounts Receivable | + | Office Equipment | +      | Office Supplies | = | Accounts Payable | + | Preya Palit, Capital |
| (1) | +\$20 000    |   |                     |   |                  |        |                 | = |                  |   | +\$20 000            |
| (2) | -7 000       |   |                     |   | +7 000           |        |                 | = |                  |   |                      |
|     | 13 000       |   |                     |   | 7 000            |        |                 | = |                  |   | 20 000               |
| (3) | +2 000       |   |                     |   |                  |        |                 | = |                  |   | +2 000               |
|     | 15 000       |   |                     |   | 7 000            |        |                 | = |                  |   | 22 000               |
| (4) |              |   | +6 000              |   |                  |        |                 | = |                  |   | +6 000               |
|     | 15 000       | + | 6 000               | + | 7 000            |        |                 | = |                  |   | 28 000               |
| (5) |              |   |                     |   |                  | +3 000 |                 | = | +3 000           |   |                      |
|     | 15 000       | + | 6 000               | + | 7 000            | +      | 3 000           | = | 3 000            | + | 28 000               |
| (6) | +4 000       |   | -4 000              |   |                  |        |                 | = |                  |   |                      |
|     | 19 000       | + | 2 000               | + | 7 000            | +      | 3 000           | = | 3 000            | + | 28 000               |
| (7) | -8 000       |   |                     |   |                  |        |                 | = |                  |   | -8 000               |
|     | 11 000       | + | 2 000               | + | 7 000            | +      | 3 000           | = | 3 000            | + | 20 000               |
| (8) |              |   |                     |   |                  | -2 000 |                 | = |                  |   | -2 000               |
|     | 11 000       | + | 2 000               | + | 7 000            | +      | 1 000           | = | 3 000            | + | 18 000               |
| (9) | -3 000       |   |                     |   |                  |        |                 | = | -3 000           |   |                      |
|     | \$ 8 000     | + | \$ 2 000            | + | \$ 7 000         | +      | \$ 1 000        | = | \$ 0             | + | \$ 18 000            |

- (1) Preya Palit invested \$20 000 into the business.
- (2) Purchased office equipment for cash \$7000.
- (3) Preya Palit invested a further \$2000 into the business, OR sold services for cash.
- (4) Performed services and billed clients for \$6000.
- (5) Office supplies of \$3000 were bought on credit.
- (6) \$4000 was received from clients for amounts owed (accounts receivable).
- (7) Preya Palit withdrew \$8000 from the business, or expense paid in cash.
- (8) \$2000 worth of office supplies were used.
- (9) Paid accounts payable \$3000 owed to them.

## Exercise 2.11

### Recording transactions

#### Non-GST version

Jones' Mower Repairs began operations on 1 August 2019 and completed the following transactions during the first month.

1. Darren Jones deposited \$35 000 of his personal funds in a current account at a bank opened in the name of the business.
2. Mower repair equipment was purchased at a cost of \$24 000, of which \$14 000 was paid in cash. A loan payable was given for the remainder.
3. Darren collected \$5000 from customers for repair services performed.
4. Shop rent was paid for the month of August, \$1500.
5. Supplies amounting to \$2100 were purchased on credit.
6. Wages of \$1200 were paid as well as an account for electricity, \$250.
7. Darren paid for the supplies purchased in (5) above.
8. Supplies used during August amounted to \$750.

#### Required

- (a) Prepare a schedule. List the following assets, liabilities and equity as column headings: Cash at Bank; Supplies; Equipment; Loan Payable; Accounts Payable; D. Jones, Capital.
- (b) Show the effects of each of the transactions on the accounts listed. Indicate totals after each transaction and complete the schedule.
- (c) Prepare an income statement and a statement of changes in equity for the month ended 31 August 2019, and a balance sheet as at 31 August 2019. (LO3 and LO5)

(a) and (b)

|     | Assets       |   |          | = | Liabilities |   | +                | Equity |              |   |                   |
|-----|--------------|---|----------|---|-------------|---|------------------|--------|--------------|---|-------------------|
|     | Cash at Bank | + | Supplies | + | Equipment   | = | Accounts Payable | +      | Loan Payable | + | D. Jones, Capital |
| (1) | \$35 000     |   |          |   |             | = |                  | +      |              | + | \$35 000          |
| (2) | -14 000      | + |          |   | \$24 000    | = |                  |        | \$10 000     |   |                   |
|     | 21 000       | + |          |   | 24 000      | = |                  |        | 10 000       | + | 35 000            |
| (3) | + 5 000      |   |          |   |             |   |                  |        |              | + | 5 000             |
|     | 26 000       | + |          | + | 24 000      | = |                  | +      | 10 000       | + | 40 000            |
| (4) | -1 500       |   |          |   |             |   |                  |        |              | - | 1 500             |
|     | 24 500       | + |          |   | 24 000      | = |                  | +      | 10 000       | + | 38 500            |
| (5) |              | + | 2 100    |   |             |   | 2 100            |        |              |   |                   |
|     | 24 500       | + | 2 100    | + | 24 000      | = | 2 100            | +      | 10 000       | + | 38 500            |
| (6) | -1 450       |   |          |   |             |   |                  |        |              | - | 1 450             |
|     | 23 050       | + | 2 100    | + | 24 000      | = | 2 100            | +      | 10 000       | + | 37 050            |
| (7) | -2 100       |   |          |   |             |   | -2 100           |        |              |   |                   |
|     | 20 950       | + | 2 100    | + | 24 000      | = | 0                | +      | 10 000       | + | 37 050            |
| (8) |              | - | 750      |   |             |   |                  |        |              | - | 750               |
|     | 20 950       | + | 1 350    | + | 24 000      | = | 0                | +      | 10 000       | + | 36 300            |

(c)

| <b>JONES' MOWER REPAIRS</b>               |         |         |
|---|---------|---------|
| <b>Income Statement</b>                   |         |         |
| <b>for the month ended 31 August 2019</b> |         |         |
| <b>INCOME</b>                             |         |         |
| Services income                           |         | \$5 000 |
| <b>EXPENSES</b>                           |         |         |
| Rent expense                              | \$1 500 |         |
| Wages expense                             | 1 200   |         |
| Electricity expense                       | 250     |         |
| Supplies used                             | 750     |         |
|   |         | 3 700   |
| <b>PROFIT</b>                             |         | \$1 300 |

| <b>JONES'MOWER REPAIRS</b>                |          |
|---|----------|
| <b>Statement of Changes in Equity</b>     |          |
| <b>for the month ended 31 August 2019</b> |          |
| D. Jones, Capital – 1 August 2016         | \$0      |
| Add: Capital contribution                 | 35 000   |
| Profit for the month                      | 1 300    |
|   | 36 300   |
| Less: Drawings during the month           | 0        |
| D. Jones, Capital – 31 August 2016        | \$36 300 |

| <b>JONES'MOWER REPAIRS</b>  |                 |
|-----------------------------|-----------------|
| <b>Balance Sheet</b>        |                 |
| <b>as at 31 August 2019</b> |                 |
| <b>ASSETS</b>               |                 |
| Cash at bank                | \$20 950        |
| Supplies                    | 1 350           |
| Equipment                   | 24 000          |
| <b>TOTAL ASSETS</b>         | <b>\$46 300</b> |
| <b>LIABILITIES</b>          |                 |
| Accounts payable            | \$—             |
| Loan payable                | 10 000          |
| <b>TOTAL LIABILITIES</b>    | <b>10 000</b>   |
| <b>NET ASSETS</b>           | <b>\$36 300</b> |
| <b>EQUITY</b>               |                 |
| D. Jones, Capital           | \$36 300        |
| <b>TOTAL EQUITY</b>         | <b>\$36 300</b> |

## **Exercise 2.11**

### **Recording transactions**

#### **GST version**

**Jones' Mower Repairs began operations on 1 August 2019 and completed the following transactions during the first month.**

- 1. Darren Jones deposited \$35 000 of his personal funds in a current account at a bank opened in the name of the business.**
- 2. Mower repair equipment was purchased at a cost of \$24 000 plus GST (10%), of which \$16 400 was paid in cash. A loan payable was given for the remainder.**
- 3. Darren collected \$5000 plus GST (10%) from customers for repair services performed.**
- 4. Shop rent was paid for the month of August, \$1500 plus GST (10%).**
- 5. Supplies amounting to \$2100 plus GST (10%) were purchased on credit.**
- 6. Wages of \$1200 were paid as well as an account for electricity, \$250 plus GST (10%).**
- 7. Darren paid for the supplies purchased in (5) above.**
- 8. Supplies used during August amounted to \$750.**

#### **Required**

- (a) Prepare a schedule. List the following assets, liabilities and equity as column headings: Cash at Bank; GST Receivable; Supplies; Equipment; GST Payable; Loan Payable; Accounts Payable; D. Jones, Capital.**
- (b) Show the effects of each of the transactions on the accounts listed. Indicate totals after each transaction and complete the schedule.**
- (c) Prepare an income statement and a statement of changes in equity for the month ended 31 August 2019, and a balance sheet as at 31 August 2019. (LO3 and LO5)**

(a) and (b)

|   |              | Assets         |          |           | = | Liabilities |                  | +            | Equity            |
|---|--------------|----------------|----------|-----------|---|-------------|------------------|--------------|-------------------|
|   | Cash at Bank | GST Receivable | Supplies | Equipment |   | GST Payable | Accounts Payable | Loan Payable | D. Jones, Capital |
|   | +            | +              | +        |           | = | +           | +                | +            |                   |
| 1 | \$35,000     |                |          |           | = |             |                  |              | + \$35,000        |
| 2 | 16,400       | \$ 2,400       |          | \$ 24,000 |   |             |                  | \$10,000     |                   |
|   | 18,600       | 2,400          |          | 24,000    | = |             |                  | 10,000       | + 35,000          |
| 3 | 5,500        |                |          |           |   | \$ 500      |                  |              | + 5,000           |
|   | 24,100       | 2,400          |          | 24,000    | = | 500         |                  | 10,000       | + 40,000          |
| 4 | 1,650        | 150            |          |           |   |             |                  |              | - 1,500           |
|   | 22,450       | 2,550          |          | 24,000    | = | 500         |                  | 10,000       | + 38,500          |
| 5 |              | 210            | \$ 2,100 |           |   |             | \$ 2,310         |              |                   |
|   | 22,450       | 2,760          | 2,100    | 24,000    | = | 500         | 2,310            | 10,000       | + 38,500          |
| 6 | 1,475        | 25             |          |           |   |             |                  |              | - 1,450           |
|   | 20,975       | 2,785          | 2,100    | 24,000    | = | 500         | 2,310            | 10,000       | + 37,050          |
| 7 | 2,310        |                |          |           |   |             | - 2,310          |              |                   |
|   | 18,665       | 2,785          | 2,100    | 24,000    | = | 500         | 0                | 10,000       | + 37,050          |
| 8 |              | - 750          |          |           |   |             |                  |              | - 750             |
|   | 18,665       | 2,785          | 1,350    | 24,000    | = | 500         | -                | 10,000       | + 36,300          |

(c)

| <b>JONES' MOWER REPAIRS</b>               |         |         |
|---|---------|---------|
| <b>Income Statement</b>                   |         |         |
| <b>for the month ended 31 August 2019</b> |         |         |
| <b>INCOME</b>                             |         |         |
| Services income                           |         | \$5 000 |
| <b>EXPENSES</b>                           |         |         |
| Rent expense                              | \$1 500 |         |
| Wages expense                             | 1 200   |         |
| Electricity expense                       | 250     |         |
| Supplies used                             | 750     |         |
|   |         | 3 700   |
| <b>PROFIT</b>                             |         | \$1 300 |

| <b>JONES' MOWER REPAIRS</b>               |          |
|---|----------|
| <b>Statement of Changes in Equity</b>     |          |
| <b>for the month ended 31 August 2019</b> |          |
| D. Jones, Capital – 1 August 2016         | \$0      |
| Add: Capital contribution                 | 35 000   |
| Profit for the month                      | 1 300    |
|   | 36 300   |
| Less: Drawings during the month           | 0        |
| D. Jones, Capital – 31 August 2016        | \$36 300 |

| <b>JONES' MOWER REPAIRS</b> |  |                 |
|-----------------------------|--|-----------------|
| <b>Balance Sheet</b>        |  |                 |
| <b>as at 31 August 2019</b> |  |                 |
| <b>ASSETS</b>               |  |                 |
| Cash at bank                |  | \$18 665        |
| GST receivable              |  | 2 785           |
| Supplies                    |  | 1 350           |
| Equipment                   |  | 24 000          |
| <b>TOTAL ASSETS</b>         |  | <b>\$46 800</b> |
| <b>LIABILITIES</b>          |  |                 |
| GST payable                 |  | \$500           |
| Accounts payable            |  | 0               |
| Loan payable                |  | 10 000          |
| <b>TOTAL LIABILITIES</b>    |  | <b>10 000</b>   |
| <b>NET ASSETS</b>           |  | <b>\$36 300</b> |
| <b>EQUITY</b>               |  |                 |
| D. Jones, Capital           |  | \$36 300        |
| <b>TOTAL EQUITY</b>         |  | <b>\$36 300</b> |

## Exercise 2.12

### Preparation of income statement and balance sheet

Toby and Talea McKellar are the joint owners of Beaut Beach Caravan Park, which is near a swimming beach popular during the summer months. The park provides not only camping facilities for caravans and tents but also up-market cabins with kitchenettes and ensuites. For the year ended 30 June 2019, Toby and Talea determined the following financial information for their business:

|                           |           |                     |           |
|---------------------------|-----------|---------------------|-----------|
| Cash on hand              | \$ 20 000 | Accounts payable    | \$ 87 000 |
| Buildings purchased       | 420 000   | Accounts receivable | 8 000     |
| Income — cabins           | 272 000   | Income — camping    | 185 000   |
| Salaries and wages        | 220 000   | Supplies on hand    | 15 000    |
| Supplies used             | 71 000    | Other expenses      | 45 000    |
| Other equipment purchased | 63 000    |                     |           |

A real estate agent valued the buildings at \$500 000 on 30 June 2019.

#### Required

(a) Prepare an income statement for Beaut Beach Caravan Park for the year ended 30 June 2019.

(b) Prepare a balance sheet for the business as at 30 June 2019.

(c) Explain why you have used a particular valuation for the buildings in the balance sheet.

(LO3 and LO4)

(a)

| <b>BEAUT BEACH CARAVAN PARK</b>        |               |                  |
|--|---------------|------------------|
| <b>Income Statement</b>                |               |                  |
| <b>for the year ended 30 June 2019</b> |               |                  |
| <b>INCOME</b>                          |               |                  |
| Income — camping                       |               | \$185 000        |
| Income — cabins                        |               | <u>272 000</u>   |
|  |               | 457 000          |
| <b>EXPENSES</b>                        |               |                  |
| Salaries and wages expense             | \$220 000     |                  |
| Other expenses                         | 45 000        |                  |
| Supplies used                          | <u>71 000</u> |                  |
|  |               | 336 000          |
| <b>PROFIT</b>                          |               | <u>\$121 000</u> |

(b)

| <b>BEAUT BEACH CARAVAN PARK</b>   |                  |
|-----------------------------------|------------------|
| <b>Balance Sheet</b>              |                  |
| <b>as at 30 June 2019</b>         |                  |
| <b>ASSETS</b>                     |                  |
| Cash on hand                      | \$20 000         |
| Accounts receivable               | 8 000            |
| Supplies                          | 15 000           |
| Buildings                         | 420 000          |
| Other equipment                   | 63 000           |
| <b>TOTAL ASSETS</b>               | <b>\$526 000</b> |
| <b>LIABILITIES</b>                |                  |
| Accounts payable                  | \$87 000         |
| <b>TOTAL LIABILITIES</b>          | <b>\$87 000</b>  |
| <b>NET ASSETS</b>                 | <b>\$439 000</b> |
| <b>EQUITY</b>                     |                  |
| Toby and Talea McKellar, Capital* | \$439 000        |
| <b>TOTAL EQUITY</b>               | <b>\$439 000</b> |

\* Normally, separate capital accounts are maintained for each partner in the business, but the question does not say whether they both contributed equally to the partnership, nor how they were sharing profits between themselves.

(c) Even though the market value of the buildings had risen to \$500 000 by 30 June 2019, the valuation placed on the buildings in the balance sheet is their purchase price. This assumes that the business is a going concern and that the owners are not going to sell up and close the business down (going concern assumption). Hence, there is no need to reflect the current selling price in the balance sheet.

Nevertheless, if the owners wanted to revalue the buildings to \$500 000, they could. The revaluation of buildings in the accounts of an entity is discussed in a later chapter.

## Exercise 2.13

### Effect of transactions on a balance sheet

The following events occurred during the month of September 2019 for the business of Eliza's Webdesign Service.

|         |  |
|---------|--|
| Sept. 1 | Eliza deposited \$40 000 cash into the business bank account.  |
| 2       | A computer, telephone system and printer were purchased at a cost of \$10 000 cash.                            |
| 4       | A part-time receptionist was hired to commence in October 2019.  |
| 6       | Web design services were provided to clients for \$12 000. The clients were invoiced but have not as yet paid. |
| 7       | Advertising for the week amounts to \$1000 cash.   |
| 8       | A customer paid \$3000 in advance for web design services scheduled for October.                               |

### Required

- (a) Determine the effects of business transactions on a balance sheet by preparing a new balance sheet for Eliza's Webdesign Service after each transaction has occurred.
- (b) Discuss the expected tasks of Eliza as the manager of Eliza's Webdesign Service.

(LO5)

(a) Effect of each business transaction on balance sheet:

Sept. 1            Capital investment by owner, \$40 000.

| <b>ELIZA'S WEBDESIGN SERVICE</b> |                 |
|----------------------------------|-----------------|
| <b>Balance Sheet</b>             |                 |
| <b>as at 1 September 2019</b>    |                 |
| <b>ASSETS</b>                    |                 |
| Cash on hand                     | \$40 000        |
| <b>TOTAL ASSETS</b>              | <b>\$40 000</b> |
| <b>EQUITY</b>                    |                 |
| Eliza, Capital                   | \$40 000        |
| <b>TOTAL EQUITY</b>              | <b>\$40 000</b> |

Sept. 2 Purchase of computer, telephone system and printer for \$10 000 cash.

| <b>ELIZA'S WEBDESIGN SERVICE</b> |  |                 |
|----------------------------------|--|-----------------|
| <b>Balance Sheet</b>             |  |                 |
| <b>as at 2 September 2019</b>    |  |                 |
| <b>ASSETS</b>                    |  |                 |
| Cash on hand                     |  | \$30 000        |
| Equipment                        |  | 10 000          |
| <b>TOTAL ASSETS</b>              |  | <b>\$40 000</b> |
| <b>EQUITY</b>                    |  |                 |
| Eliza, Capital                   |  | \$40 000        |
| <b>TOTAL EQUITY</b>              |  | <b>\$40 000</b> |

Sept.4 Hire of part-time receptionist (no change on balance sheet).

| <b>ELIZA'S WEBDESIGN SERVICE</b> |  |                 |
|----------------------------------|--|-----------------|
| <b>Balance Sheet</b>             |  |                 |
| <b>as at 4 September 2019</b>    |  |                 |
| <b>ASSETS</b>                    |  |                 |
| Cash on hand                     |  | \$30 000        |
| Equipment                        |  | 10 000          |
| <b>TOTAL ASSETS</b>              |  | <b>\$40 000</b> |
| <b>EQUITY</b>                    |  |                 |
| Eliza, Capital                   |  | \$40 000        |
| <b>TOTAL EQUITY</b>              |  | <b>\$40 000</b> |

Sept. 6 Webdesign services provided to clients for \$12 000, but not yet beenpaid.

| <b>ELIZA'S WEBDESIGN SERVICE</b> |  |                 |
|----------------------------------|--|-----------------|
| <b>Balance Sheet</b>             |  |                 |
| <b>as at 6 September 2019</b>    |  |                 |
| <b>ASSETS</b>                    |  |                 |
| Cash on hand                     |  | \$30 000        |
| Accounts receivable              |  | 12 000          |
| Equipment                        |  | 10 000          |
| <b>TOTAL ASSETS</b>              |  | <b>\$52 000</b> |
| <b>EQUITY</b>                    |  |                 |
| Eliza, Capital                   |  | \$52 000        |
| <b>TOTAL EQUITY</b>              |  | <b>\$52 000</b> |

Sept. 7 Advertising paid for \$1000 in cash.

| <b>ELIZA'S WEBDESIGN SERVICE</b> |  |                 |
|----------------------------------|--|-----------------|
| <b>Balance Sheet</b>             |  |                 |
| <b>as at 7 September 2019</b>    |  |                 |
| <b>ASSETS</b>                    |  |                 |
| Cash on hand                     |  | \$29 000        |
| Accounts receivable              |  | 12 000          |
| Equipment                        |  | 10 000          |
| <b>TOTAL ASSETS</b>              |  | <b>\$51 000</b> |
| <b>EQUITY</b>                    |  |                 |
| Eliza, Capital                   |  | \$51 000        |
| <b>TOTAL EQUITY</b>              |  | <b>\$51 000</b> |

Sept. 8 Customer paid \$3000 in advance for web design services scheduled for October.

| <b>ELIZA'S WEBDESIGN SERVICE</b> |  |                 |
|----------------------------------|--|-----------------|
| <b>Balance Sheet</b>             |  |                 |
| <b>as at 8 September 2019</b>    |  |                 |
| <b>ASSETS</b>                    |  |                 |
| Cash on hand                     |  | \$32 000        |
| Accounts receivable              |  | 12 000          |
| Equipment                        |  | 10 000          |
| <b>TOTAL ASSETS</b>              |  | <b>\$54 000</b> |
| <b>LIABILITIES</b>               |  |                 |
| Unearned revenue                 |  | \$3 000         |
| <b>TOTAL LIABILITIES</b>         |  | <b>3 000</b>    |
| <b>NET ASSETS</b>                |  | <b>\$51 000</b> |
| <b>EQUITY</b>                    |  |                 |
| Eliza, Capital                   |  | \$51 000        |
| <b>TOTAL EQUITY</b>              |  | <b>\$51 000</b> |

(b) The expected tasks of Eliza as the manager of Webdesign Service.

As the owner-manager of Webdesign Service, Eliza needs to ensure that her business achieves satisfactory financial performance (e.g. achieves its target profit). Although Webdesign Service is small sole trader, Eliza (as the manager) is still required to perform some managerial tasks as follow.

- **Planning:** in order for her business to be successful, Eliza needs to plan for future by setting goals to be achieved and making sure that future operations of the business are both effective and efficient. As part of planning, Eliza must decide what action the business should take in the future and what strategies should be implemented to achieve the business' goals. For example, Eliza might want to expand the business. In order to do that, she would need to plan how this can be done, e.g. how to get more capital (from her own finance or bank loan), how many more employees she needs to hire to help her doing clients' orders, and whether to move to bigger premises.
- **Organising:** as the sole manager in the business, Eliza needs to do a lot of organising so that the business is able to operate effectively and efficiently. Some of the things Eliza needs to organise would include: purchasing supplies and equipment required, paying bills, hiring and training new employees, and negotiating with clients.
- **Directing:** this managerial function deals with the day-to-day management of the business. As a manager, Eliza needs to be able to communicate the business' goals to her employees and provide direction/guidance for them to achieve the goals. This includes answering questions from her employees and resolving problems/disagreements with them.
- **Controlling:** to make sure that the actual performance of the business is in line with the business' goals, Eliza's role as a manager requires her to regularly evaluate her business' performance and compare it with the target. If there are significant variations from expected results, then actions need to be taken to improve the efficiency and effectiveness of business operations. For example, Eliza may want to compare the actual time spent in finishing clients' orders to the expected time. If the evaluation shows that it mostly takes longer for her employees to finish the orders, she would need to investigate causes of the variation and take actions accordingly (e.g. provide more training to current employees, hire more employees).

## Exercise 2.14

### Effects of transactions on financial statements

List the effect of each of the following transactions upon any or all of the four financial statements of a business. Apart from indicating the financial statement(s) involved, use appropriate phrases such as 'increase total assets', 'decrease equity', 'increase income', 'decrease cash flow' to describe the transaction concerned.

- (a) Purchase equipment for cash
  - (b) Provide services to a client, with payment to be received within 40 days
  - (c) Pay a liability
  - (d) Invest additional cash into the business by the owner
  - (e) Collect an account receivable in cash
  - (f) Pay wages to employees
  - (g) Receive the electricity bill in the mail, to be paid within 30 days
  - (h) Sell a piece of equipment for cash
  - (i) Withdraw cash by the owner for private usage.
  - (j) Borrow money on a long-term basis from a bank
- (LO5)

- (a) In the balance sheet, increase an asset, equipment; decrease an asset, cash.  
In the statement of cash flows, decrease cash flow (from investing activities).
- (b) In the balance sheet, increase an asset, receivables; increase equity.  
In the income statement, increase income.  
In the statement of changes in equity, increase equity.
- (c) In the balance sheet, decrease an asset, cash; decrease liability.  
In the statement of cash flows, decrease cash (probably from operating activities).
- (d) In the balance sheet, increase an asset, cash; increase equity.  
In the statement of cash flows, increase cash (from financing activities).  
In the statement of changes in equity, equity is increased.
- (e) In the balance sheet, increase an asset, cash; decrease an asset, accounts receivable. In the statement of cash flows, increase cash (from operating activities).
- (f) In the balance sheet, decrease an asset, cash; decrease equity.  
In the income statement, increase expenses.  
In the statement of cash flows, decrease cash (from operating activities).  
In the statement of changes in equity, decrease equity.
- (g) In the balance sheet, decrease equity; increase a liability, accounts payable.  
In the income statement, increase expenses.  
In the statement of changes in equity, decrease equity.

- (h) In the balance sheet, increase an asset, cash; decrease an asset, equipment, increase equity (if a profit was made on the sale).  
In the income statement, increase income (if a profit was made on the sale).  
In the statement of cash flows, increase cash (from investing activities).  
In the statement of changes in equity, increase equity (if a profit was made on the sale).
- (i) In the balance sheet, decrease equity, decrease an asset, cash.  
In the statement of cash flows, decrease cash (from financing activities).  
In the statement of changes in equity, decrease equity.
- (j) In the balance sheet, increase an asset, cash; increase a liability, loan payable.  
In the statement of cash flows, increase cash (from financing activities).

**Exercise 2.15****Determination of profit by examining equity changes**

Eric Lu began a small business on 1 July 2018 by depositing \$250 000 into a business bank account. On 30 June for the next 3 years, the assets and liabilities of the business were as follows:

| 30 June | Total assets | Total liabilities |
|---------|--------------|-------------------|
| 2019    | \$580 000    | \$350 000         |
| 2020    | 650 000      | 370 000           |
| 2021    | 740 000      | 420 000           |

**Required**

By analysing the changes in equity each year, calculate the profit (loss) made by the business for each year ending 30 June, assuming the following events also occurred:

- (a) On 1 January 2019, Eric withdrew \$20 000 in cash from the business for personal use.
  - (b) On 28 August 2019, Eric invested additional cash of \$30 000 into the business.
  - (c) On 31 July 2020, Eric invested additional cash of \$25 000 into the business.
  - (d) On 28 January 2021, Eric withdrew \$30 000 in cash for personal use.
- (LO4 and LO5)

| <b>ERIC LU'S BUSINESS</b>          |           |               |               |
|------------------------------------|-----------|---------------|---------------|
| Profit for years ended 30 June     | 2019      | 2020          | 2021          |
| Beginning Capital 1 July           | \$250 000 | \$230 000     | \$280 000     |
| + Additional Capital Contributions | —         | 30 000        | 25 000        |
| – Drawings                         | (20 000)  |               | (30 000)      |
| <b>Profit</b>                      | —         | <b>20 000</b> | <b>45 000</b> |
| Ending Capital*30 June             | \$230 000 | \$280 000     | \$320 000     |

\* Assets minus liabilities at the end of each year

## Problems

### Problem 2.16

#### Preparing financial statements

Financial data for Safety Hire as of 30 June 2019 are:

|                         |           |                     |           |
|-------------------------|-----------|---------------------|-----------|
| Accounts receivable     | \$ 63 000 | Wages expense       | \$ 75 000 |
| Equipment hire income   | 170 000   | Advertising expense | 30 000    |
| Accounts payable        | 40 000    | Land                | 75 000    |
| Michael Donato, capital | ?         | Hire equipment      | 180 000   |
| Cash at bank            | 45 000    | Loan payable        | 50 000    |
| Mortgage payable        | 130 000   | Electricity expense | 18 000    |
| Building                | 85 000    | Telephone expense   | 7 500     |

#### Required

- Prepare an income statement for the month of June and a balance sheet in account format for Safety Hire as at 30 June 2019.
  - Discuss if, and how, the financial reports that you have prepared would change if you were aware that the wages expense included \$20 000 of drawings by the owner of Safety Hire.
- (LO3, LO4 and LO5)

(a) Income statement and balance sheet for Safety Hire:

| <b>SAFETY HIRE</b>                      |          |                 |
|---|----------|-----------------|
| <b>Income Statement</b>                 |          |                 |
| <b>For the month ended 30 June 2019</b> |          |                 |
| <b>INCOME</b>                           |          |                 |
| Equipment hire income                   |          | \$170 000       |
| <b>EXPENSES</b>                         |          |                 |
| Wages expense                           | \$75 000 |                 |
| Advertising expense                     | 30 000   |                 |
| Electricity expense                     | 18 000   |                 |
| Telephone expense                       | 7 500    |                 |
|   |          | 130 500         |
| <b>PROFIT</b>                           |          | <b>\$39 500</b> |

| <b>SAFETY HIRE</b>        |                         |                    |                         |
|---------------------------|-------------------------|--------------------|-------------------------|
| <b>Balance Sheet</b>      |                         |                    |                         |
| <b>as at 30 June 2019</b> |                         |                    |                         |
| <b>ASSETS</b>             |                         | <b>LIABILITIES</b> |                         |
| Cash at bank              | \$45 000                | Accounts payable   | \$40 000                |
| Accounts receivable       | 63 000                  | Loan payable       | 50 000                  |
| Hire equipment            | 180 000                 | Mortgage payable   | 130 000                 |
| Building                  | 85 000                  |                    | <u>220 000</u>          |
| Land                      | 75 000                  | <b>EQUITY</b>      |                         |
|                           |                         | Michael Donato,    | 228 000                 |
|                           |                         | Capital            |                         |
|                           | <u><b>\$448 000</b></u> |                    | <u><b>\$448 000</b></u> |

(b) Effects on financial report if wages expense included \$20 000 drawings by owner:

The *Conceptual Framework* defines expenses as decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants (para. 70(b)). Applying this definition, drawings is not an expense as it is a decrease in economic benefits (which decreases equity) as a result of distribution to equity participants (i.e. owner).

If the wages expense of \$75 000 incurred by Safety Hire for the month ended 30 June 2019 includes \$20 000 of drawings by the owner, the \$20 000 drawings must be recorded separately from wages expense. As drawings is not an expense, it should not be recorded in the income statement. Rather, it should be recorded in the statement of changes in equity to determine the closing balance of capital as at 30 June 2019.

After separating drawings from wages expense, the total wages expense for the month would be \$55 000 (i.e. \$75 000 less \$20 000) and expenses \$110 500. Consequently, profit for the month would increase by \$20 000 to \$59 500, as shown in the revised income statement for Safety Hire as follow:

| <b>SAFETY HIRE</b>                      |          |                 |
|---|----------|-----------------|
| <b>Income Statement</b>                 |          |                 |
| <b>For the month ended 30 June 2019</b> |          |                 |
| <b>INCOME</b>                           |          |                 |
| Equipment hire income                   |          | \$170 000       |
| <b>EXPENSES</b>                         |          |                 |
| Wages expense                           | \$55 000 |                 |
| Advertising expense                     | 30 000   |                 |
| Electricity expense                     | 18 000   |                 |
| Telephone expense                       | 7 500    |                 |
|   |          | <u>110 500</u>  |
| <b>PROFIT</b>                           |          | <u>\$59 500</u> |

The \$20 000 drawings is recorded in the statement of changes in equity to calculate the closing balance of capital as at 30 June 2019. Although profit has increased by \$20 000 as shown in the revised income statement above and this increases capital, the \$20 000 drawings would decrease capital by \$20 000. Hence, the closing balance of capital would remain the same at \$228 000 as at 30 June 2019.

**Problem 2.17**

**Preparing financial statements**

Asset, liability, equity, income and expense amounts for Sadoka’s Interior Decorating at 30 June 2019 are presented below:

|                            |           |                     |           |
|----------------------------|-----------|---------------------|-----------|
| Cash at bank               | \$ 22 800 | Advertising expense | \$ 36 000 |
| Accounts receivable        | 117 600   | Insurance expense   | 8 000     |
| Supplies                   | 26 400    | Rent expense        | 33 000    |
| Equipment                  | 125 600   | Supplies expense    | 12 600    |
| Accounts payable           | 33 700    | Telephone expense   | 12 200    |
| Sadoka Nato, capital       | ?         | Electricity expense | 17 000    |
| Decorating services income | 386 000   | Wages expense       | 111 000   |

**Required**

- Prepare an income statement for the business for the year ended 30 June 2019.
  - Prepare a balance sheet in narrative format as at 30 June 2019.
  - Explain succinctly the differences in the information conveyed by an income statement and a statement of cash flows.
- (LO3, LO4 and LO5)

(a)

| <b>SADOKA’S INTERIOR DECORATING</b>    |          |           |
|--|----------|-----------|
| <b>Income Statement</b>                |          |           |
| <b>for the year ended 30 June 2019</b> |          |           |
| <b>INCOME</b>                          |          |           |
| Decorating services income             |          | \$386 000 |
|  |          | 0         |
| <b>EXPENSES</b>                        |          |           |
| Advertising expense                    | \$36 000 |           |
|  | 0        |           |
| Insurance expense                      | 8 000    |           |
| Rent expense                           | 33 000   |           |
| Supplies expense                       | 12 600   |           |
| Telephone expense                      | 12 200   |           |
| Electricity expense                    | 17 000   |           |
| Wages expense                          | 111 000  |           |
|  | 0        |           |
|  |          | 229 800   |
| <b>PROFIT</b>                          |          | \$156 200 |
|  |          | 0         |

(b)

| <b>SADOKA'S INTERIOR DECORATING</b> |                  |
|-------------------------------------|------------------|
| <b>Balance Sheet</b>                |                  |
| <b>as at 30 June 2019</b>           |                  |
| <b>ASSETS</b>                       |                  |
| Cash at bank                        | \$22 800         |
| Accounts receivable                 | 117 600          |
| Supplies                            | 26 400           |
| Equipment                           | 125 600          |
| <b>TOTAL ASSETS</b>                 | <b>\$292 400</b> |
| <b>LIABILITIES</b>                  |                  |
| Accounts payable                    | 33 700           |
| <b>TOTAL LIABILITIES</b>            | <b>\$33 700</b>  |
| <b>NET ASSETS</b>                   | <b>\$258 700</b> |
| <b>EQUITY</b>                       |                  |
| Sadoka Nato, Capital                | 258 700          |
| <b>TOTAL EQUITY</b>                 | <b>\$258 700</b> |

(c) An income statement reports the results of financial performance for a specific time period. It lists all income and expenses of the entity for the reporting period, and shows profit/loss for the period as the difference between the income and expenses. A statement of cash flows reports the cash inflows and outflows of an entity for a specified time period resulting from operating activities (e.g. paying wages, receiving money from customer), investing activities (e.g. purchasing equipment in cash), and financing activities (e.g. borrowing money from bank, owner's drawing).

There is an overlap between income statement and statement of cash flows, in the sense that all cash income and expenses will be recorded in the statement of cash flows under operating activities. However, the income statement also includes income earned on credit (i.e. not yet received from customers) and expenses incurred on credit (i.e. not yet paid by the entity), which will not be recorded in the statement of cash flows. The income statement is prepared on an accrual basis. The statement of cash flows also includes cash inflows and outflows from other transactions other than income and expense related transactions in addition to cash income and cash expenses, for instance paying for equipment purchased and cash withdrawn by owner for personal use.

In summary, the income statement conveys information about the entity's income and expenses for the period (both cash and credit), whereas the statement of cash flows conveys information about the entity's cash inflows and outflows which include cash income, expenses, and other cash transactions.

**Problem 2.18****Determining missing elements in an accounting equation**

Calculate the two missing amounts for each independent case below.

| Case | Total assets | Total liabilities | Equity    | Total income | Total expenses | Profit (loss) |
|------|--------------|-------------------|-----------|--------------|----------------|---------------|
| A    | \$ 90 000    | \$37 000          | ?         | \$76 000     | ?              | \$24 000      |
| B    | \$110 000    | ?                 | \$ 82 000 | \$45 000     | \$58 000       | ?             |
| C    | ?            | \$18 000          | \$ 53 000 | \$80 000     | ?              | (\$10 000)    |
| D    | \$ 93 000    | ?                 | \$ 50 000 | ?            | \$32 000       | (\$18 000)    |
| E    | ?            | \$55 000          | \$120 000 | ?            | \$60 000       | \$31 000      |

(LO5)

| Case | Total Assets     | Total liabilities | Total equity    | Total income    | Total expenses  | Profit (loss)     |
|------|------------------|-------------------|-----------------|-----------------|-----------------|-------------------|
| A    | \$90 000         | \$37 000          | <b>\$53 000</b> | \$76 000        | <b>\$52 000</b> | \$24 000          |
| B    | \$110 000        | <b>\$28 000</b>   | \$82 000        | \$45 000        | \$56 000        | <b>\$(11 000)</b> |
| C    | <b>\$71 000</b>  | \$18 000          | \$53 000        | \$80 000        | <b>\$90 000</b> | (\$10 000)        |
| D    | \$93 000         | <b>\$43 000</b>   | \$50 000        | <b>\$14 000</b> | \$32 000        | (\$18 000)        |
| E    | <b>\$175 000</b> | \$55 000          | \$120 000       | <b>\$91 000</b> | \$60 000        | \$31 000          |

## Problem 2.19

### Identifying transactions from balance sheet changes

During October 2019, Cleo organised a new business, Cleo's Cafe. After each October transaction, Cleo prepared a balance sheet, as shown below.

| (1) CLEO'S CAFE<br>Balance Sheet<br>as at 4 October 2019 |                |  |               |           |
|--|----------------|--|---------------|-----------|
| ASSETS   |                |  | EQUITY        |           |
| Cash at bank   | \$175 000      |  | Cleo, Capital | \$175 000 |
|  | <u>175 000</u> |  |               |           |

  

| (2) CLEO'S CAFE<br>Balance Sheet<br>as at 13 October 2019 |                |  |               |                |
|---|----------------|--|---------------|----------------|
| ASSETS  |                |  | EQUITY        |                |
| Cash at bank  | \$ 46 000      |  | Cleo, Capital | \$175 000      |
| Tables and chairs   | 129 000        |  |               |                |
|   | <u>175 000</u> |  |               | <u>175 000</u> |

  

| (3) CLEO'S CAFE<br>Balance Sheet<br>as at 18 October 2019 |                |  |                        |                |
|---|----------------|--|------------------------|----------------|
| ASSETS  |                |  | LIABILITIES AND EQUITY |                |
| Cash at bank  | \$ 26 000      |  | Loan payable           | \$ 60 000      |
| Tables and chairs   | 129 000        |  | Cleo, Capital          | 175 000        |
| Coffee machines   | 80 000         |  |                        |                |
|   | <u>235 000</u> |  |                        | <u>235 000</u> |

  

| (4) CLEO'S CAFE<br>Balance Sheet<br>as at 26 October 2019 |                |  |                        |                |
|---|----------------|--|------------------------|----------------|
| ASSETS  |                |  | LIABILITIES AND EQUITY |                |
| Cash at bank  | \$ 26 000      |  | Accounts payable       | \$ 18 000      |
| Supplies  | 18 000         |  | Loan payable           | 60 000         |
| Coffee machines   | 80 000         |  |                        | 78 000         |
| Tables and chairs   | 129 000        |  | Cleo, Capital          | 175 000        |
|   | <u>253 000</u> |  |                        | <u>253 000</u> |

### Required

- Describe the nature of each of the four transactions that took place during October.
  - Comment on the type of financial information conveyed in a balance sheet.
  - Write a retort to the statement that 'a balance sheet should only be prepared once a year'.
- (LO3, LO4 and LO5)

- (a) The four transactions that took place during October are as follows:
- (i) On 4 October 2019, Cleo invested \$175 000 into the business, Cleo's Café.
  - (ii) On 13 October 2019, tables and chairs were purchased by the business for cash, \$129 000.
  - (iii) On 18 October 2019, coffee machines were purchased for a total of \$80 000. The machines were purchased using \$20 000 cash with the balance (\$60 000) obtained from a bank loan.
  - (iv) On 26 October 2019, supplies of \$18 000 were purchased by the business on credit.

(b) A balance sheet is a report that lists the items that the business owns and owes to external parties and internal parties (owners). It reports the assets, liabilities, and equity at a specific point in time, usually the end of the reporting period (hence it is titled 'as at...'). The balances of various individual asset accounts (e.g. cash, accounts receivables, equipment) and liability accounts (e.g. accounts payable, wages payable, mortgage payable) are listed on the balance sheet, along with the balance of equity (for sole traders like Cleo's Café, it is usually the closing balance of capital).

There are two formats that can be used to prepare the balance sheet, which are the account format and the narrative format. The former shows assets on the left-hand side and liabilities and equity on the right hand side, whereas the latter lists all elements of balance sheet in one column. Regardless of the format used, the balance sheet must show the equality of accounting equation. That is, when account format is used, the balance sheet must show that total assets on the left-hand side equal total liabilities plus equity on the right-hand side. When narrative format is used, the balance sheet must show that net assets (i.e. total assets less total liabilities) equal total equity.

(c) Publicly listed companies are required to prepare balance sheet at least once a year, which is at the end of their reporting period. This means that balance sheet does not have to be prepared only once a year. As explained in part B above, a balance sheet reports the assets, liabilities, and equity at a specific point in time. Hence, entities can prepare a balance sheet as at any date. Although publicly listed companies must report their financial position to shareholders (i.e. external users) once a year, managers of the companies (i.e. internal users) might need to know their companies' financial position at a specific point in time in order to make decision about the companies' operations. Monthly reporting for internal purposes often includes an income statement, balance sheet and statement of cash flow.

## Problem 2.20

### Preparation of financial statements

Dawson Industries began operations early in January 2020. On 31 December 2020, records showed the following asset, liability, equity, income and expense amounts:

|                     |           |                      |        |
|---------------------|-----------|----------------------|--------|
| Accounts receivable | \$ 25 600 | Lila Dawson, Capital | \$ ?   |
| Rent expense        | 13 500    | Electricity expense  | 7 200  |
| Cash at bank        | 10 250    | Telephone expense    | 4 900  |
| Supplies expense    | 5 250     | Advertising expense  | 12 500 |
| Accounts payable    | 9 500     | Insurance expense    | 2 500  |
| Service income      | 147 500   | Wages expense        | 44 000 |
| Supplies            | 11 000    | Drawings             | 23 400 |
| Equipment           | 48 000    |                      |        |

### Required

- Prepare an income statement for Dawson Industries for the year ended 31 December 2020.
- Prepare a balance sheet as at 31 December 2020.
- Prepare a statement of changes in equity for 2020.
- Explain the difference between the items 'supplies' and 'supplies expense'. (LO3, LO4 and LO5)

(a)

| <b>DAWSON INDUSTRIES</b>                   |         |           |
|--|---------|-----------|
| <b>Income Statement</b>                    |         |           |
| <b>for the year ended 31 December 2020</b> |         |           |
| <b>INCOME</b>                              |         |           |
| Service income                             |         | \$147 500 |
| <b>EXPENSES</b>                            |         |           |
| Advertising expense                        | \$12 50 |           |
|  | 0       |           |
| Insurance expense                          | 2 500   |           |
| Rent expense                               | 13 500  |           |
| Supplies expense                           | 5 250   |           |
| Telephone expense                          | 4 900   |           |
| Electricity expense                        | 7 200   |           |
| Wages expense                              | 44 000  |           |
|  |         | 89 850    |
| <b>PROFIT</b>                              |         | \$57 650  |

(b)

| <b>DAWSON INDUSTRIES</b>      |                 |
|-------------------------------|-----------------|
| <b>Balance Sheet</b>          |                 |
| <b>as at 31 December 2020</b> |                 |
| <b>ASSETS</b>                 |                 |
| Cash at bank                  | \$10 250        |
| Accounts receivable           | 25 600          |
| Supplies                      | 11 000          |
| Equipment                     | 48 000          |
| <b>TOTAL ASSETS</b>           | <b>\$94 850</b> |
| <b>LIABILITIES</b>            |                 |
| Accounts payable              | 9 500           |
| <b>TOTAL LIABILITIES</b>      | <b>\$9 500</b>  |
| <b>NET ASSETS</b>             | <b>\$85 350</b> |
| <b>EQUITY</b>                 |                 |
| Lila Dawson, Capital          | 85 350          |
| <b>TOTAL EQUITY</b>           | <b>\$85 350</b> |

(c)

| <b>DAWSON INDUSTRIES</b>                   |                 |
|--|-----------------|
| <b>Statement of Changes in Equity</b>      |                 |
| <b>for the year ended 31 December 2020</b> |                 |
| Lila Dawson, Capital – 1 January 2017      | —               |
| Add: Capital contribution                  | \$51 100        |
| Profit for the year                        | 57 650          |
|  | 108 750         |
| Less: Drawings during the year             | 23 400          |
| Lila Dawson, Capital – 31 December 2017    | <b>\$85 350</b> |

(d) The term 'supplies' refers to items purchased by an entity to be used as part of its operations (e.g. stationery). Supplies are usually purchased in bulk, and then are consumed or used during the period. At the time of purchase, supplies are recorded as assets to the entity because they have future economic benefits in the form of their use for the entity's operation and they are controlled by the entity (i.e. the entity owns the supplies) as a result of past event (which is the purchase transaction). As an asset account, supplies are recorded on the balance sheet.

'Supplies expense' refers to supplies that have been used or consumed by the entity in their operation during the period. Whilst unused supplies are assets to the entity, used supplies are recorded as expense because they are decreases in economic benefits (from the consumption by the entity) in the form of decreases in assets (i.e. supplies account). Furthermore, these decreases in economic benefits result in decreases in equity, and they are not distributions to owners (i.e. the entity consumes the economic benefits, not the owners). As an expense account, supplies expense is recorded on the income statement.

**Problem 2.21**

**Correction of financial statements**

A new business graduate with one subject of accounting prepared the financial statements below for Helen's Dancing School at the end of the first year of operations.

| HELEN'S DANCING SCHOOL<br>Income Statement<br>for the year ended 30 June 2019 |  |                   |                  |
|---|--|-------------------|------------------|
| INCOME  |  |                   |                  |
| Dancing fees  |  |                   | \$ 115 000       |
| EXPENSES  |  |                   |                  |
| Studio rent expense   |  | \$18 000          |                  |
| Wages expense   |  | 43 000            |                  |
| Supplies expense  |  | 16 200            |                  |
| Electricity expense   |  | 6 750             |                  |
| H. Horner, Drawings   |  | 11 200            |                  |
| Depreciation expense  |  |                   |                  |
| — vehicle   |  | 3 200             |                  |
| — equipment   |  | 4 300             |                  |
|   |  | <u>          </u> |                  |
|   |  |                   | 102 650          |
| PROFIT  |  |                   | <u>\$ 12 350</u> |

| Balance Sheet<br>as at 30 June 2019 |                 |                    |                 |
|-------------------------------------|-----------------|--------------------|-----------------|
| ASSETS                              |                 | LIABILITIES        |                 |
| Cash at bank                        | \$12 600        | Accounts payable   | \$13 000        |
| Equipment                           | 17 800          | EQUITY             |                 |
| Vehicle                             | 20 700          | H. Horner, Capital | 38 100          |
|                                     | <u>\$51 100</u> |                    | <u>\$51 100</u> |

**Additional analysis revealed the following:**

1. Dancing fees of \$7500 (owed by customers) were unrecorded at 30 June.
2. Additional equipment of \$10 500 purchased with a bank loan at the end of the month had not been recorded.
3. Supplies on hand at 30 June costing \$10 600 were included in expenses.
4. Wages of \$2500 were payable at 30 June.

**Required**

- (a) Prepare a corrected income statement for the year ended 30 June 2019.
- (b) Prepare a corrected balance sheet in narrative form as at 30 June 2019.
- (c) Prepare a statement of changes in equity for the year ended 30 June 2019.
- (d) Discuss the accounting assumptions that the graduate has breached. (LO3, LO4 and LO5)

(a)

| <b>HELEN'S DANCING SCHOOL</b>          |              |                        |
|--|--------------|------------------------|
| <b>Income Statement</b>                |              |                        |
| <b>for the year ended 30 June 2019</b> |              |                        |
| <b>INCOME</b>                          |              |                        |
| Dancing fees                           |              | \$122 500              |
| <b>EXPENSES</b>                        |              |                        |
| Studio rent expense                    | \$18 000     |                        |
| Wages expense                          | 45 500       |                        |
| Supplies expense                       | 5 600        |                        |
| Electricity expense                    | 6 750        |                        |
| Depreciation expense                   |              |                        |
| — vehicle                              | 3 200        |                        |
| — equipment                            | 4 300        |                        |
|  | <u>7 500</u> |                        |
|  |              | <u>83 350</u>          |
| <b>PROFIT</b>                          |              | <u><u>\$39 150</u></u> |

(b)

| <b>HELEN'S DANCING SCHOOL</b> |                      |
|-------------------------------|----------------------|
| <b>Balance Sheet</b>          |                      |
| <b>as at 30 June 2019</b>     |                      |
| <b>ASSETS</b>                 |                      |
| Cash at bank                  | \$12 600             |
| Accounts receivable           | 7 500                |
| Supplies on hand              | 10 600               |
| Equipment                     | 28 300               |
| Vehicle                       | 20 700               |
| <b>TOTAL ASSETS</b>           | <u>79 700</u>        |
| <b>LIABILITIES</b>            |                      |
| Accounts payable              | 13 000               |
| Wages payable                 | 2 500                |
| Bank loan                     | 10 500               |
| <b>TOTAL LIABILITIES</b>      | <u>26 000</u>        |
| <b>NET ASSETS</b>             | <u><b>53 700</b></u> |
| <b>EQUITY</b>                 |                      |
| H. Horner, Capital            | <u>53 700</u>        |
| <b>TOTAL EQUITY</b>           | <u><u>53 700</u></u> |

(c)

| <b>HELEN'S DANCING SCHOOL</b>          |                     |
|--|---------------------|
| <b>Statement of Changes in Equity</b>  |                     |
| <b>for the year ended 30 June 2019</b> |                     |
| H. Horner, Capital – 1 July 2018*      | 25750               |
| Add: Profit for the year               | 39 150              |
|  | <u>64900</u>        |
| Less: Drawings during the year         | 11 200              |
| H. Horner, Capital – 30 June 2019      | <u><u>53700</u></u> |

\*Beginning balance of capital is found by working backwards, namely,  $\$53700 + \$11\,200 - \$39\,150$ . This assumes that the owner did not make a capital contribution during the year.

(d) The graduate mainly has breached the *accrual basis assumption*, which states that financial statements of an entity are assumed to be prepared using accrual basis. Under the accrual basis, income (expenses) is (are) recognised in the period when increases (decreases) in economic benefits occur, rather than when cash is received or paid.

The accrual basis assumption was breached as the graduate initially:

- Did not record \$7500 dancing fees owed by customers as income for the year ended 30 June 2019. The dancing lesson was provided during that period, and therefore under the accrual basis the \$7500 dancing fees were earned in that period even though the customers have not yet paid; the amount owing should be recorded as an asset on the balance sheet.
- Did not record the \$2500 wages owed by the dancing school to its employees as expenses for the year ended 30 June 2019. The employees have provided services to the dancing school during the period, and therefore under the accrual basis the \$2500 wages payable was incurred in that period even though the employees have not yet been paid.
- Included \$10 600 unused supplies as expenses in the year ended 30 June 2019. Under the accrual basis, expenses are to be recognised when decreases in economic benefits have occurred (i.e. when supplies are used), and therefore unused supplies should not be recognised as expenses. Instead, they should be recorded as assets on the balance sheet.

## **Problem 2.22**

### **Performance assessment from financial statements**

The Marketing Store was established as a sole trader business, specialising in providing marketing services, on 1 January 2019. The owner, Jenny Smart, contributed \$100 000 in cash to the business and did not withdraw funds for the year.

For the year ended 31 December 2019, the following events occurred in the business:

1. Received \$280 000 cash for marketing services provided.
2. Paid cash expenses of \$200 000 for office supplies and labour.
3. At the end of the year, the business purchased a vehicle for \$32 000 cash and a new computer design system for \$50 000 cash.
4. The business leases premises as an office. Lease rental payments for the year amounted to \$33 000.
5. The business purchased for \$80 000 a block of land on which Jenny hopes to build an office in the new year. To help pay for the land, the business had to borrow \$30 000 from a bank in cash.

### **Required**

- (a) Prepare an income statement for The Marketing Store for the year ended 31 December 2019.
  - (b) Prepare a statement of cash flows for The Marketing Store for the year ended 31 December 2019.
  - (c) Discuss if a business can operate profitably and still have a net cash outflow for the year.
  - (d) Provide a counter argument to the statement that 'a better indicator of an entity's performance is cash flow'.
- (LO3, LO4 and LO5)

(a)

| <b>THE MARKETING STORE</b>                 |           |                 |
|--|-----------|-----------------|
| <b>Income Statement</b>                    |           |                 |
| <b>for the year ended 31 December 2019</b> |           |                 |
| <b>INCOME</b>                              |           |                 |
| Marketing services                         |           | \$280 000       |
| <b>EXPENSES</b>                            |           |                 |
| Supplies and labour expense                | \$200 000 |                 |
| Rent expense                               | 33 000    | 233 000         |
| <b>PROFIT</b>                              |           | <u>\$47 000</u> |

(b)

| <b>THE MARKETING STORE</b>                  |                  |                 |
|---|------------------|-----------------|
| <b>Statement of Cash Flows</b>              |                  |                 |
| <b>for the year ended 31 December 2019</b>  |                  |                 |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b> |                  |                 |
| Cash received from customers                | \$280 000        |                 |
| Cash paid to suppliers and employees        | <u>(233 000)</u> |                 |
| Net cash from operating activities          |                  | \$47 000        |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b> |                  |                 |
| Purchase of vehicle                         | (32 000)         |                 |
| Purchase of design system                   | (50 000)         |                 |
| Purchase of land                            | <u>(80 000)</u>  |                 |
| Net cash used in investing activities       |                  | (162 000)       |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b> |                  |                 |
| Bank loan                                   | 30 000           |                 |
| Drawings by owner                           | <u>—</u>         |                 |
| Net cash from financing activities          |                  | 30 000          |
| Net increase (decrease) in cash held        |                  | (85 000)        |
| Cash at beginning of year                   |                  | <u>100 000</u>  |
| Cash at end of year                         |                  | <u>\$15 000</u> |

(c) Yes. In accrual accounting, cash flows do differ from income and expenses. For example, cash flows from investing and financing activities will affect cash outflows but are not income and expenses counted in calculating profit. Most cash flows from operating activities also result in income or expenses, but in different time periods. Many cash flows from investing and financing activities never result in income or expenses e.g. cash increases from borrowings.

(d) An entity's performance is generally assessed from three different perspectives: liquidity (i.e. ability to meet short-term obligations when they are due), solvency (i.e. ability to survive in a longer period of time), and profitability (i.e. operating success as measured by profit). Liquidity is associated with cash flows in the short-term, solvency is associated with both cash flow and profit in the long-term, and profitability is associated with profit in both short-term and long-term.

The three different performance assessments above indicate that both profit and cash flows are important indicators of an entity's performance. Cash flows are important as insufficient cash can cause liquidity problems and result in the entity being liquidated. On the other hand, profit is also important because the entity will fail if it does not generate sufficient profit to continue its operations. Subsequently, cash flows are not a better indicator of an entity's performance. Although the entity can have positive cash flows while trading at a loss in the short-term, it is not sustainable for the entity to keep operating at a loss in the long-term. Hence, cash flows and profits are both important indicators of an entity's performance and assist to provide information that is useful for decision-making.

## Problem 2.23

### Recording transactions and preparing financial statements

#### Non-GST version

Financial balances for the car hire business of John's Limos on 31 March 2019 are provided below in a table in accounting equation form similar to the chapter illustrations.

| Assets       |   |                     |   |                  | = | Liabilities    |   | +             | Equity |                  |   |              |   |                     |
|--------------|---|---------------------|---|------------------|---|----------------|---|---------------|--------|------------------|---|--------------|---|---------------------|
| Cash at Bank | + | Accounts Receivable | + | Office Equipment | + | Motor Vehicles | + | Fuel Supplies | =      | Accounts Payable | + | Loan Payable | + | John Limos, Capital |
| \$11 000     | + | \$15 000            | + | \$1 500          | + | \$94 000       | + | 0             | =      | \$3 500          | + | \$12 000     | + | \$106 000           |

During April, the business of John's Limos entered into the following transactions:

1. Collected \$8000 of the accounts receivable.
2. Paid \$2000 of the accounts payable.
3. Purchased another vehicle for \$48 000. Paid \$5000 in cash and signed a loan agreement for the balance.
4. Billed customers for services performed, \$10 500.
5. Fuel supplies purchased on credit, \$3750.
6. Paid expenses in cash, \$4250 (wages, \$2400; car cleaning \$1200; advertising, \$650).
7. John Limos withdrew \$2000 for personal use.
8. Paid parking fines of \$300.

#### Required

- (a) List the 31 March balances for assets, liabilities and equity in table form as shown below.
  - (b) Record the effects of each transaction. Show the total of each column after recording each transaction.
  - (c) Prepare an income statement, a statement of changes in equity and a statement of cash flows for the month ended 30 April 2019, and a balance sheet (account format) as at 30 April 2019.
- (LO3, LO4 and LO5)

(a) and (b)

|     |                 | Assets |                        |   |                  |   | =                   | Liabilities |                   | + | Equity              |   |                  |   |                        |
|-----|-----------------|--------|------------------------|---|------------------|---|---------------------|-------------|-------------------|---|---------------------|---|------------------|---|------------------------|
|     | Cash at<br>Bank | +      | Accounts<br>Receivable | + | Fuel<br>Supplies | + | Office<br>Equipment | +           | Motor<br>Vehicles | = | Accounts<br>Payable | + | Loans<br>Payable | + | John Limos,<br>Capital |
|     | \$11 000        | +      | \$15 000               | + | 0                | + | \$1 500             | +           | \$94 000          | = | \$3 500             | + | \$12 000         | + | \$106 000              |
| (1) | + 8 000         |        | - 8 000                |   |                  |   |                     |             |                   |   |                     |   |                  |   |                        |
|     | 19 000          | +      | 7 000                  | + | 0                | + | 1 500               | +           | 94 000            | = | 3 500               | + | 12 000           | + | 106 000                |
| (2) | - 2 000         |        |                        |   |                  |   |                     |             |                   |   | - 2 000             |   |                  |   |                        |
|     | 17 000          | +      | 7 000                  | + | 0                | + | 1 500               | +           | 94 000            | = | 1 500               | + | 12 000           | + | 106 000                |
| (3) | - 5 000         |        |                        |   |                  |   |                     |             | +48 000           |   |                     |   | +43 000          |   |                        |
|     | 12 000          | +      | 7 000                  | + | —                | + | 1 500               | +           | 142 000           | = | 1 500               | + | 55 000           | + | 106 000                |
| (4) |                 |        | +10 500                |   |                  |   |                     |             |                   |   |                     |   |                  |   | +10 500                |
|     | 12 000          | +      | 17 500                 | + | —                | + | 1 500               | +           | 142 000           | = | 1 500               | + | 55 000           | + | 116 500                |
| (5) |                 |        |                        | + | 3 750            |   |                     |             |                   |   | + 3 750             |   |                  |   |                        |
|     | 12 000          | +      | 17 500                 | + | 3 750            | + | 1 500               | +           | 142 000           | = | 5 250               | + | 55 000           | + | 116 500                |
| (6) | - 4 250         |        |                        |   |                  |   |                     |             |                   |   |                     |   |                  |   | - 4 250                |
|     | 7 750           | +      | 17 500                 | + | 3 750            | + | 1 500               | +           | 142 000           | = | 5 250               | + | 55 000           | + | 112 250                |
| (7) | - 2 000         |        |                        |   |                  |   |                     |             |                   |   |                     |   |                  |   | - 2 000                |
|     | 5 750           | +      | 17 500                 | + | 3 750            | + | 1 500               | +           | 14 2000           | = | 5 250               | + | 55 000           | + | 110 250                |
| (8) | -300            |        |                        |   |                  |   |                     |             |                   |   |                     |   |                  |   | - 300                  |
|     | 5 450           | +      | 17 500                 | + | 3 750            | + | 1 500               | +           | 142 000           | = | 5 250               | + | 55 000           | + | 109 950                |

(c)

| <b>JOHN'S LIMOS</b>                      |              |                       |
|--|--------------|-----------------------|
| <b>Income Statement</b>                  |              |                       |
| <b>for the month ended 30 April 2019</b> |              |                       |
| <b>INCOME</b>                            |              |                       |
| Services income                          |              | \$10 500              |
| <b>EXPENSES</b>                          |              |                       |
| Wages expense                            | \$2 400      |                       |
| Car cleaning expense                     | 1 200        |                       |
| Advertising expense                      | 650          |                       |
| Parking fines expense                    | 300          |                       |
|  | <u>4 550</u> |                       |
| <b>PROFIT</b>                            |              | <u><u>\$5 950</u></u> |

| <b>JOHN'S LIMOS</b>                      |                         |
|--|-------------------------|
| <b>Statement of Changes in Equity</b>    |                         |
| <b>for the month ended 30 April 2019</b> |                         |
| John Limos, Capital – 1 April 2019       | \$106 000               |
| Add: Profit for the month                | 5 950                   |
|  | <u>111 950</u>          |
| Less: Drawings during the month          | 2 000                   |
| John Limos, Capital – 30 April 2019      | <u><u>\$109 950</u></u> |

| <b>JOHN'S LIMOS</b>                         |                |                       |
|---|----------------|-----------------------|
| <b>Statement of Cash Flows</b>              |                |                       |
| <b>for the month ended 30 April 2019</b>    |                |                       |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b> |                |                       |
| Cash received from customers                | \$8 000        |                       |
| Cash paid to suppliers and employees (1)    | <u>(6 550)</u> |                       |
| Net cash from operating activities          |                | \$1 450               |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b> |                |                       |
| Purchase of vehicle                         | <u>(5 000)</u> |                       |
| Net cash used in investing activities       |                | (5 000)               |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b> |                |                       |
| Drawings by owner                           | <u>(2 000)</u> |                       |
| Net cash used in financing activities       |                | <u>(2 000)</u>        |
| Net decrease in cash held                   |                | (5 550)               |
| Cash at beginning of month                  |                | <u>11 000</u>         |
| Cash at end of month                        |                | <u><u>\$5 450</u></u> |

(1) Paid Accounts Payable \$2000 + Cash Expenses \$4250 + Parking fines \$300  
 = \$6550

| <b>JOHN'S LIMOS</b>        |                         |                     |                         |
|----------------------------|-------------------------|---------------------|-------------------------|
| <b>Balance Sheet</b>       |                         |                     |                         |
| <b>as at 30 April 2019</b> |                         |                     |                         |
| <b>ASSETS</b>              |                         | <b>LIABILITIES</b>  |                         |
| Cash at bank               | \$5 450                 | Accounts payable    | \$5 250                 |
| Accounts receivable        | 17 500                  | Loan payable        | 55 000                  |
| Fuel supplies              | 3 750                   | <b>EQUITY</b>       |                         |
| Office equipment           | 1 500                   | John Limos, Capital | 109 950                 |
| Motor vehicles             | <u>142 000</u>          |                     |                         |
|                            | <u><b>\$170 200</b></u> |                     | <u><b>\$170 200</b></u> |

**Problem 2.23**

**Recording transactions and preparing financial statements**

**GST version**

Financial balances for the car hire business of John’s Limos on 31 March 2019 are provided below in a table in accounting equation form similar to the chapter illustrations.

| Assets       |                |                     |               |          |                  | =              | Liabilities      |             |               | +        | Equity              |         |   |         |   |          |   |           |
|--------------|----------------|---------------------|---------------|----------|------------------|----------------|------------------|-------------|---------------|----------|---------------------|---------|---|---------|---|----------|---|-----------|
| Cash at Bank | GST Receivable | Accounts Receivable | Fuel Supplies | +        | Office Equipment | Motor Vehicles | Accounts Payable | GST Payable | Loans Payable |          | John Limos, Capital |         |   |         |   |          |   |           |
| \$12,500     | +              | \$800               | +             | \$15,000 | +                | \$0            | +                | \$1,500     | +             | \$94,000 | =                   | \$3,500 | + | \$2,300 | + | \$12,000 | + | \$106,000 |

During April, the business of John’s Limos entered into the following transactions:

1. Collected \$8000 of the accounts receivable.
2. Paid \$2000 of the accounts payable.
3. Purchased another vehicle for \$48 000 plus GST (10%). Paid \$10 000 in cash and signed a loan agreement for the balance.
4. Billed customers for services performed, \$10 500 plus GST (10%).
5. Fuel supplies purchased on credit, \$3750 plus GST (10%).
6. Paid expenses in cash, \$4250 (wages, \$2400; car cleaning \$1200 plus GST (10%); advertising, \$650 plus GST (10%)).
7. John Limos withdrew \$2000 for personal use.
8. Paid parking fines of \$300 plus GST (10%).

**Required**

- (a) List the 31 March balances for assets, liabilities and equity in table form as shown below.
- (b) Record the effects of each transaction. Show the total of each column after recording each transaction.
- (c) Prepare an income statement, a statement of changes in equity and a statement of cash flows for the month ended 30 April 2019, and a balance sheet (account format) as at 30 April 2019.  
(LO3, LO4 and LO5)

(a) and (b)

|     | Assets       |                |                     |               |                  | =              | Liabilities      |             |               | +                   | Equity |
|-----|--------------|----------------|---------------------|---------------|------------------|----------------|------------------|-------------|---------------|---------------------|--------|
|     | Cash at Bank | GST Receivable | Accounts Receivable | Fuel Supplies | Office Equipment | Motor Vehicles | Accounts Payable | GST Payable | Loans Payable | John Limos, Capital |        |
|     | +            | +              | +                   | +             | +                | =              | +                | +           | +             | +                   |        |
|     | \$12,500     | \$800          | \$15,000            | \$0           | \$1,500          | \$94,000       | \$3,500          | \$2,300     | \$12,000      | \$106,000           |        |
| (1) | 8,000        |                | (8,000)             |               |                  |                |                  |             |               |                     |        |
|     | 20,500       | 800            | 7,000               | 0             | 1,500            | 94,000         | 3,500            | 2,300       | 12,000        | 106,000             |        |
| (2) | (2,000)      |                |                     |               |                  |                | (2,000)          |             |               |                     |        |
|     | 18,500       | 800            | 7,000               | 0             | 1,500            | 94,000         | 1,500            | 2,300       | 12,000        | 106,000             |        |
| (3) | (10,000)     | 4,800          |                     |               |                  | 48,000         |                  |             | 42,800        |                     |        |
|     | 8,500        | 5,600          | 7,000               | 0             | 1,500            | 142,000        | 1,500            | 2,300       | 54,800        | 106,000             |        |
| (4) |              |                | 11,550              |               |                  |                |                  | 1,050       |               | 10,500              |        |
|     | 8,500        | 5,600          | 18,550              | 0             | 1,500            | 142,000        | 1,500            | 3,350       | 54,800        | 116,500             |        |
| (5) |              | 375            |                     | 3,750         |                  |                | 4,125            |             |               |                     |        |
|     | 8,500        | 5,975          | 18,550              | 3,750         | 1,500            | 142,000        | 5,625            | 3,350       | 54,800        | 116,500             |        |
| (6) | (4,435)      | 185            |                     |               |                  |                |                  |             |               | (4,250)             |        |
|     | 4,065        | 6,160          | 18,550              | 3,750         | 1,500            | 142,000        | 5,625            | 3,350       | 54,800        | 112,250             |        |
| (7) | (2,000)      |                |                     |               |                  |                |                  |             |               | (2,000)             |        |
|     | 2,065        | 6,160          | 18,550              | 3,750         | 1,500            | 142,000        | 5,625            | 3,350       | 54,800        | 110,250             |        |
| (8) | (330)        | 30             |                     |               |                  |                |                  |             |               | (300)               |        |
|     | 1,735        | 6,190          | 18,550              | 3,750         | 1,500            | 142,000        | 5,625            | 3,350       | 54,800        | 109,950             |        |

(c)

| <b>JOHN'S LIMOS</b>                      |              |                       |
|--|--------------|-----------------------|
| <b>Income Statement</b>                  |              |                       |
| <b>for the month ended 30 April 2019</b> |              |                       |
| <b>INCOME</b>                            |              |                       |
| Services income                          |              | \$10 500              |
| <b>EXPENSES</b>                          |              |                       |
| Wages expense                            | \$2 400      |                       |
| Car cleaning expense                     | 1 200        |                       |
| Advertising expense                      | 650          |                       |
| Parking fines expense                    | 300          |                       |
|  | <u>4 550</u> |                       |
| <b>PROFIT</b>                            |              | <u><u>\$5 950</u></u> |

| <b>JOHN'S LIMOS</b>                      |                         |
|--|-------------------------|
| <b>Statement of Changes in Equity</b>    |                         |
| <b>for the month ended 30 April 2019</b> |                         |
| John Limos, Capital – 1 April 2019       | \$106 000               |
| Add: Profit for the month                | 5 950                   |
|  | <u>111 950</u>          |
| Less: Drawings during the month          | (2 000)                 |
| John Limos, Capital – 30 April 2019      | <u><u>\$109 950</u></u> |

| <b>JOHN'S LIMOS</b>                         |                 |                       |
|---|-----------------|-----------------------|
| <b>Statement of Cash Flows</b>              |                 |                       |
| <b>for the month ended 30 April 2019</b>    |                 |                       |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b> |                 |                       |
| Cash received from customers                | \$8 000         |                       |
| Cash paid to suppliers and employees (1)    | <u>(6 765)</u>  |                       |
| Net cash from operating activities          |                 | \$1 235               |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b> |                 |                       |
| Purchase of vehicle                         | <u>(10 000)</u> |                       |
| Net cash used in investing activities       |                 | (10 000)              |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b> |                 |                       |
| Drawings by owner                           | <u>(2 000)</u>  |                       |
| Net cash used in financing activities       |                 | <u>(2 000)</u>        |
| Net decrease in cash held                   |                 | (10 765)              |
| Cash at beginning of month                  |                 | <u>12 500</u>         |
| Cash at end of month                        |                 | <u><u>\$1 735</u></u> |

(1) Paid Accounts Payable \$2000 + Cash Expenses \$4435 + Parking fines \$330  
 = \$6765

| <b>JOHN'S LIMOS</b>        |                  |                     |                  |
|----------------------------|------------------|---------------------|------------------|
| <b>Balance Sheet</b>       |                  |                     |                  |
| <b>as at 30 April 2019</b> |                  |                     |                  |
| <b>ASSETS</b>              |                  | <b>LIABILITIES</b>  |                  |
| Cash at bank               | \$1 735          | Accounts payable    | \$5 625          |
| GST receivable             | 6 190            | GST payable         | 3 350            |
| Accounts receivable        | 18 550           | Loan payable        | 54 800           |
| Fuel supplies              | 3 750            | <b>EQUITY</b>       |                  |
| Office equipment           | 1 500            | John Limos, Capital | 109 950          |
| Motor vehicles             | 142 000          |                     |                  |
|                            | <u>\$173 725</u> |                     | <u>\$173 725</u> |

## **Problem 2.24**

### **Classifying items for financial statements**

**The following list of items relate to the business of Jay Street Wear.**

- 1. Cash paid into the business by Jay to begin operations.**
- 2. Racks purchased to display merchandise to customers.**
- 3. Building leased for 2 years, with rent payable monthly in advance.**
- 4. Streetwear items purchased from a manufacturer.**
- 5. Amount owing to the manufacturer for merchandise purchased.**
- 6. Insurance premium on the merchandise paid in advance.**
- 7. Cash withdrawn by Jay for personal use.**
- 8. Wages paid to casual employee.**
- 9. Amount borrowed long-term from the bank.**
- 10. Cash sales of merchandise to customers.**
- 11. Spare change kept in the cash register at the checkout counter.**

### **Required**

- (a) Identify the elements of the financial statements (asset, liability, income, expense and equity) impacted by each of the transactions.**
  - (b) List the cash flow classification (operating, investing or financing) and direction (inflow or outflow) for each transaction.**
- (LO3, LO4 and LO5)**

(a) and (b)

1. For the business, this is the initial investment by the owner. In the balance sheet of the business, asset (cash) increases and equity increases. In the statement of cash flows, this is recorded as cash inflows under financing activities.
2. This is an asset to the business, recorded as 'Store Equipment' on the balance sheet. Assuming the racks were purchased for cash, this will be recorded as cash outflows under investing activities.
3. There is no building asset for the business here. The building does not belong to the business. In the balance sheet, an increase in the asset for Prepaid Rent and a decrease in cash would be recorded if the rent is paid by the business each month in advance. In the statement of cash flows, paying the rent in advance is recorded as a cash outflow under operating activities when the payment is made. As time passes, in the balance sheet there will be a reduction in the Prepaid Rent account for the rent that has expired. This expired rent will then be recorded as an expense (Rent Expense) in the income statement.
4. Street wear items are Inventory to the business. In the balance sheet, inventory is recorded as an asset. Assuming the street wear items were purchased in cash, this will be recorded as a cash outflow under operating activities in the statement of cash flows.

5. This is recorded as liability (Accounts Payable) in the balance sheet. Nothing is recorded in the statement of cash flows at this point. When the business pays the supplier for the amount owed, this will be recorded as a cash outflow under operating activities in the statement of cash flows.
6. This is recorded as an increase in asset (Prepaid Insurance) in the balance sheet, as well as a decrease in cash account. In the statement of cash flows, paying insurance premium is recorded as cash outflows under operating activities. As the insurance expires with the passage of time, there will be a reduction in the Prepaid Insurance account for the insurance that has expired. This expired insurance will then be recorded as an expense (Insurance Expense) in the income statement.
7. This will be recorded as a decrease in asset (cash) and a decrease in equity (Jay's capital) in the form of Drawings. In the statement of cash flows, owner's drawings are recorded as cash outflows under financing activities.
8. This will be recorded as Wages Expense in the income statement. Wages Expense does not appear in the balance sheet as a separate item but reduces equity by reducing profit. It also reduces the cash balance. Paying wages to employees is recorded as cash outflows under operating activities in the statement of cash flows.
9. Long-term borrowings are shown in the balance sheet as an increase in liability (Long-term Loan Payable), and the cash received as an increase in asset (Cash). The cash received from this loan is also recorded as cash inflows under financing activities.
10. Sales of merchandise to customers are recorded as Sales Income or Revenue in the income statement. The transaction increases equity and increases Cash or Accounts Receivable. Assuming customers pay cash for the merchandise, this will be recorded as cash inflows under operating activities in the statement of cash flows.
11. Spare change kept in the cash register is shown in the balance sheet as an asset (Cash).

**Problem 2.25**

**Recording transactions and preparing financial statements**

**Non-GST version**

Financial balances for Ho Ming Wee, Solicitor, on 30 June 2019 are given below in a table in accounting equation form similar to the chapter illustrations.

| Assets       |   |                     |   |                 | = | Liabilities      |   |                  | + | Equity       |   |                      |
|--------------|---|---------------------|---|-----------------|---|------------------|---|------------------|---|--------------|---|----------------------|
| Cash at Bank | + | Accounts Receivable | + | Office Supplies | + | Office Equipment | = | Accounts Payable | + | Loan Payable | + | Ho Ming Wee, Capital |
| \$8 000      | + | \$13 250            | + | \$1 000         | + | \$19 875         | = | \$2 425          | + | \$8 750      | + | \$30 950             |

During the early part of July, the business entered into the following transactions.

1. Paid \$2360 on accounts payable.
2. Collected \$6400 of the monies owed by clients.
3. Purchased office equipment for \$10 200. Paid \$1500 in cash and signed a loan agreement for the balance.
4. Billed customers for legal services performed, \$8820.
5. Purchased supplies on credit, \$1200.
6. Paid expenses in cash, \$9400 (advertising, \$2000; rent, \$6000; wages, \$1400).
7. Used \$500 of supplies during the period.
8. Collected \$6750 of accounts receivable.
9. Ho Ming Wee paid for a \$12 000 family holiday to Europe using the firm's bank account.

**Required**

- (a) List the 30 June balances for assets, liabilities and equity in table form.
  - (b) Record the effects of each transaction. Show the total of each column after recording each transaction as illustrated in the text.
  - (c) Prepare an income statement and a statement of changes in equity for the month and a balance sheet in narrative format as at 31 July 2019.
  - (d) Discuss if these financial statements are useful for the owner/manager of the business.
- (LO2, LO3 and LO5)

(a) and (b)

|     |  | <b>Assets</b> |   |                     |   | =               | <b>Liabilities</b> |                  |   | +                | <b>Equity</b> |              |   |                      |
|-----|--|---------------|---|---------------------|---|-----------------|--------------------|------------------|---|------------------|---------------|--------------|---|----------------------|
|     |  | Cash at Bank  | + | Accounts Receivable | + | Office Supplies | +                  | Office Equipment | = | Accounts Payable | +             | Loan Payable | + | Ho Ming Wee, Capital |
|     |  | \$8 000       | + | \$13 250            | + | \$1 000         | +                  | \$19 875         | = | \$2 425          | +             | \$8 750      | + | \$30 950             |
| (1) |  | - 2 360       |   |                     |   |                 |                    |                  |   | -2 360           |               |              |   |                      |
|     |  | 5 640         | + | 13 250              | + | 1 000           | +                  | 19 875           | = | 65               | +             | 8 750        | + | 30 950               |
| (2) |  | +6 400        |   | - 6 400             |   |                 |                    |                  |   |                  |               |              |   |                      |
|     |  | 12 040        | + | 6 850               | + | 1 000           | +                  | 19 875           | = | 65               | +             | 8 750        | + | 30 950               |
| (3) |  | - 1 500       |   |                     |   |                 | +                  | 10 200           |   |                  | +             | 8 700        |   |                      |
|     |  | 10 540        | + | 6 850               | + | 1 000           | +                  | 30 075           | = | 65               | +             | 17 450       | + | 30 950               |
| (4) |  |               | + | 8 820               |   |                 |                    |                  |   |                  |               |              | + | 8 820                |
|     |  | 10 540        | + | 15 670              | + | 1 000           | +                  | 30 075           | = | 65               | +             | 17 450       | + | 39 770               |
| (5) |  |               |   |                     | + | 1 200           |                    |                  |   | + 1 200          |               |              |   |                      |
|     |  | 10 540        | + | 15 670              | + | 2 200           | +                  | 30 075           | = | 1 265            | +             | 17 450       | + | 39 770               |
| (6) |  | - 9 400       |   |                     |   |                 |                    |                  |   |                  |               |              |   | - 9 400              |
|     |  | 1 140         | + | 15 670              | + | 2 200           | +                  | 30 075           | = | 1 265            | +             | 17 450       | + | 30 370               |
| (7) |  |               |   |                     |   |                 |                    | - 500            |   |                  |               |              |   | - 500                |
|     |  | 1 140         | + | 15 670              | + | 1 700           | +                  | 30 075           | = | 1 265            | +             | 17 450       | + | 29 870               |
| (8) |  | + 6 750       |   | - 6 750             |   |                 |                    |                  |   |                  |               |              |   |                      |
|     |  | 7 890         | + | 8 920               | + | 1 700           | +                  | 30 075           | = | 1 265            | +             | 17 450       | + | 29 870               |
| (9) |  | - 12 000      |   |                     |   |                 |                    |                  |   |                  |               |              |   | - 12 000             |
|     |  | - 4 110*      | + | 8 920               | + | 1 700           | +                  | 30 075           | = | 1 265            | +             | 17 450       | + | 17 870               |

\*Note: Cash at Bank account has a negative balance as there is not enough cash to pay for the family holidays. In this case, the business would use an overdraft facility (i.e. short-term borrowing) from bank to temporarily cover for the deficit. A bank overdraft is shown as a liability rather than a negative asset.

(c)

| <b>HO MING WEE — SOLICITOR</b>          |         |         |
|---|---------|---------|
| <b>Income Statement</b>                 |         |         |
| <b>for the month ended 31 July 2019</b> |         |         |
| <b>INCOME</b>                           |         |         |
| Legal services earned                   |         | \$8 820 |
| <b>EXPENSES</b>                         |         |         |
| Wages expense                           | \$1 400 |         |
| Rent expense                            | 6 000   |         |
| Advertising expense                     | 2 000   |         |
| Supplies expense                        | 500     |         |
|   |         | 9 900   |
| <b>LOSS</b>                             |         | \$1 080 |

| <b>HO MING WEE — SOLICITOR</b>          |          |
|---|----------|
| <b>Statement of Changes in Equity</b>   |          |
| <b>for the month ended 31 July 2019</b> |          |
| Ho Ming Wee, Capital – 1 July 2019      | \$30 950 |
| Less: Loss for the month                | 1 080    |
|   | 29 870   |
| Less: Drawings during the month         | 12 000   |
| Ho Ming Wee, Capital – 31 July 2019     | \$17 870 |

| <b>HO MING WEE — SOLICITOR</b> |                 |
|--------------------------------|-----------------|
| <b>Balance Sheet</b>           |                 |
| <b>as at 31 July 2019</b>      |                 |
| <b>ASSETS</b>                  |                 |
| Accounts receivable            | 8 920           |
| Office supplies                | 1 700           |
| Office equipment               | 30 075          |
| <b>TOTAL ASSETS</b>            | <b>\$40 695</b> |
| <b>LIABILITIES</b>             |                 |
| Bank overdraft                 | 4 110           |
| Accounts payable               | 1 265           |
| Loan payable                   | 17 450          |
| <b>TOTAL LIABILITIES</b>       | <b>\$22 825</b> |
| <b>NET ASSETS</b>              | <b>\$17 870</b> |
| <b>EQUITY</b>                  |                 |
| Ho Ming Wee, Capital           | 17 870          |
| <b>TOTAL EQUITY</b>            | <b>\$17 870</b> |

(d) In the business Ho Ming Wee — Solicitor, Ho Ming Wee is assumed to be both the owner and manager of his business. Financial statements are useful as they provide information about an entity's financial performance and position. As a manager Ho Ming Wee would need more information in order to make decisions on day-to-day operations.

Financial statements are a summary of the business' financial performance and position. Hence, the information provided in the financial statements only pertains to the entity as a whole and is highly condensed. As a manager, Ho Ming Wee needs more detailed information (not just summary and total) such as break-down of income from different clients or depreciation on equipment, to help him in making decisions. Furthermore, if Ho Ming Wee's business has different divisions, the financial statements will not report details about each division. Ho Ming Wee would need more information about each division to make a comparison and evaluation for each division.

Another limitation of financial statements is that they only report historical financial information rather than forward looking information for business planning. As a manager, Ho Ming Wee also needs non-financial information, such as client's satisfaction rate, employee turnover, percentage of new clients and repeat business. Non-financial information is present and future-oriented, and will enable Ho Ming Wee to evaluate and plan.

In summary, although financial statements are useful in providing information about an entity's financial performance and positions, managers require more information than what is contained in the financial statements in order to make decisions about the entity's operations.

**Problem 2.25**

**Recording transactions and preparing financial statements**

**GST version**

Financial balances for Ho Ming Wee, Solicitor, on 30 June 2019 are given below in a table in accounting equation form similar to the chapter illustrations.

| Assets       |                |                     |                 |   | =                | Liabilities |                  |   |             | + | Equity       |   |                      |
|--------------|----------------|---------------------|-----------------|---|------------------|-------------|------------------|---|-------------|---|--------------|---|----------------------|
| Cash at Bank | GST Receivable | Accounts Receivable | Office Supplies | + | Office Equipment | +           | Accounts Payable | + | GST Payable | + | Loan Payable | + | Ho Ming Wee, Capital |
| \$7,500      | \$1,450        | \$13,250            | \$1,000         | + | \$19,875         | =           | \$2,425          | + | \$950       | + | \$8,750      | + | \$30,950             |

During the early part of July, the business entered into the following transactions.

10. Paid \$2360 on accounts payable.
11. Collected \$6400 of the monies owed by clients.
12. Purchased office equipment for \$10 200 plus GST (10%). Paid \$2000 in cash and signed a loan agreement for the balance.
13. Billed customers for legal services performed, \$8820 plus GST (10%).
14. Purchased supplies on credit, \$1200 plus GST (10%).
15. Paid expenses in cash, \$9400 (advertising, \$2000 plus GST (10%); rent, \$6000 plus GST (10%); wages, \$1400).
16. Used \$500 of supplies during the period.
17. Collected \$6750 of accounts receivable.
18. Ho Ming Wee paid for a \$12 000 plus GST (10%) family holiday to Europe using the firm's bank account.

**Required**

- (e) List the 30 June balances for assets, liabilities and equity in table form.
  - (f) Record the effects of each transaction. Show the total of each column after recording each transaction as illustrated in the text.
  - (g) Prepare an income statement and a statement of changes in equity for the month and a balance sheet in narrative format as at 31 July 2019.
  - (h) Discuss if these financial statements are useful for the owner/manager of the business.
- (LO2, LO3 and LO5)

(a) and (b)

|     | Assets       |                |                     |                 |                  | = | Liabilities      |             |              | + Equity             |
|-----|--------------|----------------|---------------------|-----------------|------------------|---|------------------|-------------|--------------|----------------------|
|     | Cash at Bank | GST Receivable | Accounts Receivable | Office Supplies | Office Equipment |   | Accounts Payable | GST Payable | Loan Payable | Ho Ming Wee, Capital |
|     | +            | +              | +                   | +               |                  | = | +                | +           | +            |                      |
|     | \$7,500      | \$1,450        | \$13,250            | \$1,000         | \$19,875         | = | \$2,425          | \$950       | \$8,750      | \$30,950             |
| (1) | (2,360)      |                |                     |                 |                  |   | (2,360)          |             |              |                      |
|     | 5,140        | 1,450          | 13,250              | 1,000           | 19,875           | = | 65               | 950         | 8,750        | 30,950               |
| (2) | 6,400        |                | (6,400)             |                 |                  |   |                  |             |              |                      |
|     | 11,540       | 1,450          | 6,850               | 1,000           | 19,875           | = | 65               | 950         | 8,750        | 30,950               |
| (3) | (2,000)      | 1,020          |                     |                 | 10,200           |   |                  |             | 9,220        |                      |
|     | 9,540        | 2,470          | 6,850               | 1,000           | 30,075           | = | 65               | 950         | 17,970       | 30,950               |
| (4) |              |                | 9,702               |                 |                  |   |                  | 882         |              | 8,820                |
|     | 9,540        | 2,470          | 16,552              | 1,000           | 30,075           | = | 65               | 1,832       | 17,970       | 39,770               |
| (5) |              | 120            |                     | 1,200           |                  |   | 1,320            |             |              |                      |
|     | 9,540        | 2,590          | 16,552              | 2,200           | 30,075           | = | 1,385            | 1,832       | 17,970       | 39,770               |
| (6) | (10,200)     | 800            |                     |                 |                  |   |                  |             |              | (9,400)              |
|     | (660)        | 3,390          | 16,552              | 2,200           | 30,075           | = | 1,385            | 1,832       | 17,970       | 30,370               |
| (7) |              |                |                     | (500)           |                  |   |                  |             |              | (500)                |
|     | (660)        | 3,390          | 16,552              | 1,700           | 30,075           | = | 1,385            | 1,832       | 17,970       | 29,870               |
| (8) | 6,750        |                | (6,750)             |                 |                  |   |                  |             |              |                      |
|     | 6,090        | 3,390          | 9,802               | 1,700           | 30,075           | = | 1,385            | 1,832       | 17,970       | 29,870               |
| (9) | (13,200)     |                |                     |                 |                  |   |                  |             |              | *(13,200)            |
|     | *(7,110)     | 3,390          | 9,802               | 1,700           | 30,075           | = | 1,385            | 1,832       | 17,970       | 16,670               |

\*Note: Cash at Bank account has a negative balance as there is not enough cash to pay for the family holiday. In this case, the business would use an overdraft facility (i.e. short-term borrowing) from bank to temporarily cover for the deficit. A bank overdraft is shown as a liability rather than a negative asset. There is no GST Receivable for the payment of the family holiday as this is a personal expense. The GST paid cannot be claimed through the business.

(c)

| <b>HO MING WEE — SOLICITOR</b>          |         |           |
|---|---------|-----------|
| <b>Income Statement</b>                 |         |           |
| <b>for the month ended 31 July 2019</b> |         |           |
| <b>INCOME</b>                           |         |           |
| Legal services earned                   |         | \$8 820   |
| <b>EXPENSES</b>                         |         |           |
| Wages expense                           | \$1 400 |           |
| Rent expense                            | 6 000   |           |
| Advertising expense                     | 2 000   |           |
| Supplies expense                        | 500     |           |
|   |         | 9 900     |
| <b>LOSS</b>                             |         | (\$1 080) |

| <b>HO MING WEE — SOLICITOR</b>          |          |
|---|----------|
| <b>Statement of Changes in Equity</b>   |          |
| <b>for the month ended 31 July 2019</b> |          |
| Ho Ming Wee, Capital – 1 July 2019      | \$30 950 |
| Less: Loss for the month                | (1 080)  |
|   | 29 870   |
| Less: Drawings during the month         | (13 200) |
| Ho Ming Wee, Capital – 31 July 2019     | \$16 670 |

| <b>HO MING WEE — SOLICITOR</b> |                 |
|--------------------------------|-----------------|
| <b>Balance Sheet</b>           |                 |
| <b>as at 31 July 2019</b>      |                 |
| <b>ASSETS</b>                  |                 |
| GST receivable                 | 3 390           |
| Accounts receivable            | 9 802           |
| Office supplies                | 1 700           |
| Office equipment               | 30 075          |
| <b>TOTAL ASSETS</b>            | <b>\$44 967</b> |
| <b>LIABILITIES</b>             |                 |
| Bank overdraft                 | 7 110           |
| Accounts payable               | 1 385           |
| GST payable                    | 1 832           |
| Loan payable                   | 17 970          |
| <b>TOTAL LIABILITIES</b>       | <b>\$28 297</b> |
| <b>NET ASSETS</b>              | <b>\$16 670</b> |
| <b>EQUITY</b>                  |                 |
| Ho Ming Wee, Capital           | 16 670          |
| <b>TOTAL EQUITY</b>            | <b>\$16 670</b> |

(d) In the business Ho Ming Wee — Solicitor, Ho Ming Wee is assumed to be both the owner and manager of his business. Financial statements are useful as they provide information about an entity's financial performance and position. As a manager Ho Ming Wee would need more information in order to make decisions on day-to-day operations.

Financial statements are a summary of the business' financial performance and position. Hence, the information provided in the financial statements only pertains to the entity as a whole and is highly condensed. As a manager, Ho Ming Wee needs more detailed information (not just summary and total) such as break-down of income from different clients or depreciation on equipment, to help him in making decisions. Furthermore, if Ho Ming Wee's business has different divisions, the financial statements will not report details about each division. Ho Ming Wee would need more information about each division to make a comparison and evaluation for each division.

Another limitation of financial statements is that they only report historical financial information rather than forward looking information for business planning. As a manager, Ho Ming Wee also needs non-financial information, such as client's satisfaction rate, employee turnover, percentage of new clients and repeat business. Non-financial information is present and future-oriented, and will enable Ho Ming Wee to evaluate and plan.

In summary, although financial statements are useful in providing information about an entity's financial performance and positions, managers require more information than what is contained in the financial statements in order to make decisions about the entity's operations.

## Problem 2.26

## Identifying transactions from balance sheet changes

Emma Lu obtained registration to practise as a naturopath, and spent the month of July 2019 setting up her business — E. Lu, Naturopath.

Emma prepared a new balance sheet after each transaction which occurred. During July, the following balance sheets were prepared.

| (1) E. LU, NATUROPATH<br>Balance Sheet<br>as at 1 July 2019  |                  |                        |                  |
|--|------------------|------------------------|------------------|
| ASSETS   |                  | EQUITY                 |                  |
| Cash at bank   | \$85 000         | E. Lu, Capital         | \$85 000         |
| <hr/>  |                  | <hr/>                  |                  |
| (2) E. LU, NATUROPATH<br>Balance Sheet<br>as at 8 July 2019  |                  |                        |                  |
| ASSETS   |                  | LIABILITIES AND EQUITY |                  |
| Cash at bank   | \$ 50 000        | Loan payable           | \$160 000        |
| Equipment  | 25 000           | E. Lu, Capital         | 85 000           |
| Building   | 170 000          |                        |                  |
|  | <u>\$245 000</u> |                        | <u>\$245 000</u> |
| <hr/>  |                  | <hr/>                  |                  |
| (3) E. LU, NATUROPATH<br>Balance Sheet<br>as at 15 July 2019 |                  |                        |                  |
| ASSETS   |                  | LIABILITIES AND EQUITY |                  |
| Cash at bank   | \$ 50 000        | Accounts payable       | \$ 3 500         |
| Office supplies  | 3 500            | Loan payable           | 160 000          |
| Accounts receivable  | 25 000           | E. Lu, Capital         | 85 000           |
| Building   | 170 000          |                        |                  |
|  | <u>\$248 500</u> |                        | <u>\$248 500</u> |
| <hr/>  |                  | <hr/>                  |                  |
| (4) E. LU, NATUROPATH<br>Balance Sheet<br>as at 22 July 2019 |                  |                        |                  |
| ASSETS   |                  | LIABILITIES AND EQUITY |                  |
| Cash at bank   | \$ 45 000        | Accounts payable       | \$ 3 500         |
| Office supplies  | 3 500            | Loan payable           | 155 000          |
| Accounts receivable  | 25 000           | E. Lu, Capital         | 85 000           |
| Building   | 170 000          |                        |                  |
|  | <u>\$243 500</u> |                        | <u>\$243 500</u> |
| <hr/>  |                  | <hr/>                  |                  |
| (5) E. LU, NATUROPATH<br>Balance Sheet<br>as at 31 July 2019 |                  |                        |                  |
| ASSETS   |                  | LIABILITIES AND EQUITY |                  |
| Cash at bank   | \$ 41 000        | Accounts payable       | \$ 3 500         |
| Office supplies  | 3 500            | Loan payable           | 155 000          |
| Accounts receivable  | 25 000           | E. Lu, Capital         | 81 000           |
| Building   | 170 000          |                        |                  |
|  | <u>\$239 500</u> |                        | <u>\$239 500</u> |
| <hr/>  |                  | <hr/>                  |                  |

**Required**

- (a) Describe each of the five transactions that occurred during July 2019.
- (b) Emma is very focused on the environment. As a manager and owner of the business, discuss the actions that she could take to earn a reputation for having sustainable business practices.
- (c) Discuss whether you believe that disclosing sustainable business practices enhances an entity's reputation.
- (LO2 and LO5)

- (a)
- (i) On 1 July 2019, E. Lu invested \$85 000 in the business.
- (ii) On 8 July, the business purchased equipment for \$25 000 and building for \$170 000. This was financed with a cash payment of \$35 000 and a loan payable of \$160 000.
- (iii) On 15 July, the business bought office supplies on credit for \$3500.
- (iv) On 22 July, the business repaid \$5000 on the loan payable.
- (v) On 31 July, the proprietor, E. Lu, withdrew \$4000 cash for her own use or paid expenses of \$4000.

(b) The followings are examples of sustainable business practices:

- Recycling office supplies, such as papers or cardboards.
- Installing solar panels on the roof of her building to generate electricity.
- Installing water tank in her building to re-use rain water.
- Carefully selecting the suppliers of medicines or vitamins she used in her practice to include only suppliers with good environmental and ethical business conducts.
- Installing more glass windows in the building where sunlight can go through and hence the building will use less electricity for lights during the day.
- Having good insulation for the building so that inside temperature is more stable (use less heater/air conditioning).

Note: students may have other suggestions from their own experience, so it would be good to have a class discussion on this.

(c) Given the attention and concern for the environment, stakeholders/society expect businesses to be good corporate citizens in preserving and looking after the environment for future generations. In other words, the stakeholders are not just interested in the financial success (i.e. profit) of an entity, but also in how the entity manages impacts of its business operations on the environment.

There is growing demand for entities to disclose the impacts of their business on the environment and community, in addition to reporting the financial aspects of the business. This reporting, known as sustainability reporting, is not mandatory. However, growing numbers of entities (especially large listed companies) have voluntarily provided this information in order to be accountable and to increase their reputation to current and potential investors.

Many investors have become 'eco/green investors', which means they only want to invest in companies with sustainable business practices and good citizenship records. A number of sustainability indices, such as Dow Jones Sustainability Indexes, evaluate the sustainability performance of largest companies and have become

reference point in sustainability for those green investors. Companies included in the sustainability indices must make continuous improvements to their long-term sustainability plans in order to remain in the indices.

By providing information about their environmental practices, the companies would be able to demonstrate what they have done to minimise damages on the environment and be perceived as responsible corporate citizens. This, in turn, will increase their reputation that is likely to attract more capital in the market and offer competitive advantage such as increase in sales.

**Problem 2.27**

**Recording transactions and preparing financial statements**

**Non-GST version**

Tran's Clothing Alterations began operations on 1 August 2019 and completed the following transactions during the first month.

1. Tran deposited \$18 000 of her personal funds in a current account at a bank opened in the name of the business.
2. Sewing equipment was purchased at a cost of \$9000, of which \$5000 was paid in cash. A loan payable was given for the remainder of \$4000.
3. Tran collected \$1500 from customers for alteration services performed.
4. Rent was paid for the month of August, \$1200.
5. Sewing supplies amounting to \$700 were purchased on credit.
6. Wages of \$500 were paid as well as an account for electricity, \$250.
7. Tran paid for the sewing supplies purchased in (5) above.
8. Supplies used during August amounted to \$300.

**Required**

- (a) Prepare a schedule. List the following assets, liabilities and equity as column headings: Cash at Bank; Supplies; Equipment; Loan Payable; Accounts Payable; Tran, Capital.
  - (b) Illustrate the effects of each of the transactions on the accounts listed. Indicate totals after each transaction and complete the schedule.
  - (c) Prepare an income statement, a statement of cash flows and a statement of changes in equity for the month ended 31 August 2019.
  - (d) Prepare a balance sheet as at 31 August 2019.
- (LO3, LO4 and LO5)

(a) and (b)

| <b>Assets</b> |         |          |   | =         | <b>Liabilities</b> |              |       | +                | <b>Equity</b> |               |         |
|---------------|---------|----------|---|-----------|--------------------|--------------|-------|------------------|---------------|---------------|---------|
| Cash at Bank  | +       | Supplies | + | Equipment | =                  | Loan payable | +     | Accounts Payable | +             | Tran, Capital |         |
| (1)           | +18 000 |          |   |           |                    |              |       |                  | +             | 18 000        |         |
| (2)           | - 5 000 |          | + | 9 000     |                    | +4 000       |       |                  |               |               |         |
| (3)           | 13 000  | +        | 0 | +         | 9 000              | =            | 4 000 | +                | 0             | +             | 18 000  |
|               | +1 500  |          |   |           |                    |              |       |                  | +             | 1 500         |         |
| (4)           | 14 500  | +        | 0 | +         | 9 000              | =            | 4 000 | +                | 0             | +             | 19 500  |
|               | - 1 200 |          |   |           |                    |              |       |                  |               |               | - 1 200 |

| <b>Assets</b> |        |          |       | =         | <b>Liabilities</b> |              |       | +                | <b>Equity</b> |               |        |
|---------------|--------|----------|-------|-----------|--------------------|--------------|-------|------------------|---------------|---------------|--------|
| Cash at Bank  | +      | Supplies | +     | Equipment | =                  | Loan payable | +     | Accounts Payable | +             | Tran, Capital |        |
| (5)           | 13 300 | +        | 0     | +         | 9 000              | =            | 4 000 | +                | 0             | +             | 18 300 |
|               |        | +        | 700   |           |                    |              |       | +                | 700           |               |        |
| (6)           | 13 300 | +        | 700   | +         | 9 000              | =            | 4 000 | +                | 700           | +             | 18 300 |
|               | - 750  |          |       |           |                    |              |       |                  |               |               | - 750  |
| (7)           | 12 550 | +        | 700   | +         | 9 000              | =            | 4 000 | +                | 700           | +             | 17 550 |
|               | -700   |          |       |           |                    |              |       |                  | - 700         |               |        |
| (8)           | 11 850 | +        | 700   | +         | 9 000              | =            | 4 000 | +                | 0             | +             | 17 550 |
|               |        |          | - 300 |           |                    |              |       |                  |               |               | - 300  |
|               | 11 850 | +        | 400   | +         | 9 000              | =            | 4 000 | +                | 0             | +             | 17 250 |

(c)

| <b>TRAN'S CLOTHING ALTERATIONS</b>        |         |         |
|---|---------|---------|
| <b>Income Statement</b>                   |         |         |
| <b>for the month ended 31 August 2019</b> |         |         |
| <b>INCOME</b>                             |         |         |
| Services income                           |         | \$1 500 |
| <b>EXPENSES</b>                           |         |         |
| Rent expense                              | \$1 200 |         |
| Wages expense                             | 500     |         |
| Electricity expense                       | 250     |         |
| Supplies expense                          | 300     |         |
|   |         | 2 250   |
| <b>LOSS</b>                               |         | \$750   |

| <b>TRAN'S CLOTHING ALTERATIONS</b>          |         |           |
|---|---------|-----------|
| <b>Statement of Cash Flows</b>              |         |           |
| <b>for the month ended 31 August 2019</b>   |         |           |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b> |         |           |
| Cash received from customers                | \$1 500 |           |
| Cash paid to suppliers and employees*       | (2 650) |           |
| Net cash used in operating activities       |         | \$(1 150) |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b> |         |           |
| Purchase of equipment                       | (5 000) |           |
| Net cash used in investing activities       |         | (5 000)   |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b> |         |           |
| Capital contribution from owner             | 18 000  |           |
| Net cash from financing activities          |         | 18 000    |
| Net increase in cash held                   |         | 11 850    |
| Cash at beginning of month                  |         | 0         |
| Cash at end of month                        |         | \$11 850  |

\* Cash paid to suppliers and employees = Rent \$1200 + Wages \$500 + Electricity \$250 + Accounts Payable \$700 = \$2650

| <b>TRAN'S CLOTHING ALTERATIONS</b>        |                 |
|---|-----------------|
| <b>Statement of Changes in Equity</b>     |                 |
| <b>for the month ended 31 August 2019</b> |                 |
| Tran, Capital – 1 August 2019             | \$—             |
| Add: Capital contribution                 | 18 000          |
| Less: Loss for the month                  | (750)           |
| Tran, Capital – 31 August 2019            | <u>\$17 250</u> |

(d)

| <b>TRAN'S CLOTHING ALTERATIONS</b> |                  |                    |                  |
|------------------------------------|------------------|--------------------|------------------|
| <b>Balance Sheet</b>               |                  |                    |                  |
| <b>As at 31 August 2019</b>        |                  |                    |                  |
| <b>ASSETS</b>                      |                  | <b>LIABILITIES</b> |                  |
| Cash at bank                       | \$ 11 850        | Loan payable       | \$ \$4 000       |
| Supplies                           | 400              | <b>EQUITY</b>      |                  |
| Equipment                          | 9 000            | Tran, Capital      | 17 250           |
|                                    | <u>\$ 21 250</u> |                    | <u>\$ 21 250</u> |

**Problem 2.27**

**Recording transactions and preparing financial statements**

**GST version**

Tran's Clothing Alterations began operations on 1 August 2019 and completed the following transactions during the first month.

9. Tran deposited \$18 000 of her personal funds in a current account at a bank opened in the name of the business.
10. Sewing equipment was purchased at a cost of \$9900 (including GST 10%), of which \$5000 was paid in cash. A loan payable was given for the remainder of \$4900.
11. Tran collected \$1650 (including GST 10%) from customers for alteration services performed.
12. Rent was paid for the month of August, \$1320 (including GST 10%).
13. Sewing supplies amounting to \$770 (including GST 10%) were purchased on credit.
14. Wages of \$500 were paid as well as an account for electricity, \$275 (including GST 10%).
15. Tran paid for the sewing supplies purchased in (5) above.
16. Supplies used during August amounted to \$300.

**Required**

- (e) Prepare a schedule. List the following assets, liabilities and equity as column headings: Cash at Bank; GST Receivable; Supplies; Equipment; Accounts Payable; GST Payable; Loan Payable; Tran, Capital.
- (f) Illustrate the effects of each of the transactions on the accounts listed. Indicate totals after each transaction and complete the schedule.
- (g) Prepare an income statement, a statement of cash flows and a statement of changes in equity for the month ended 31 August 2019.
- (h) Prepare a balance sheet as at 31 August 2019.  
(LO3, LO4 and LO5)

(a) and (b)

|     | <b>Assets</b> |                |          |           | = | <b>Liabilities</b> |             |              | + <b>Equity</b> |     |   |       |   |         |
|-----|---------------|----------------|----------|-----------|---|--------------------|-------------|--------------|-----------------|-----|---|-------|---|---------|
|     | Cash at Bank  | GST Receivable | Supplies | Equipment |   | Accounts Payable   | GST Payable | Loan Payable | Tran, Capital   |     |   |       |   |         |
|     | +             | +              | +        |           | = | +                  | +           | +            |                 |     |   |       |   |         |
| (1) | 18,000        |                |          |           |   |                    |             |              | 18,000          |     |   |       |   |         |
| (2) | (5,000)       | 900            |          | 9,000     |   |                    |             | 4,900        |                 |     |   |       |   |         |
|     | 13,000        | +              | 900      | 0         | + | 9,000              | =           | 0            | +               | 0   | + | 4,900 | + | 18,000  |
| (3) | 1,650         |                |          |           |   |                    |             | 150          |                 |     |   |       |   | 1,500   |
|     | 14,650        | +              | 900      | 0         | + | 9,000              | =           | 0            | +               | 150 |   | 4,900 | + | 19,500  |
| (4) | (1,320)       |                | 120      |           |   |                    |             |              |                 |     |   |       |   | (1,200) |
|     | 13,330        | +              | 1,020    | 0         | + | 9,000              | =           | 0            | +               | 150 |   | 4,900 | + | 18,300  |
| (5) |               |                | 70       | 700       |   |                    |             | 770          |                 |     |   |       |   |         |
|     | 13,330        | +              | 1,090    | 700       | + | 9,000              | =           | 770          | +               | 150 |   | 4,900 | + | 18,300  |
| (6) | (775)         |                | 25       |           |   |                    |             |              |                 |     |   |       |   | (750)   |
|     | 12,555        | +              | 1,115    | 700       | + | 9,000              | =           | 770          | +               | 150 |   | 4,900 | + | 17,550  |
| (7) | (770)         |                |          |           |   |                    |             | (770)        |                 |     |   |       |   |         |
|     | 11,785        | +              | 1,115    | 700       | + | 9,000              | =           | 0            | +               | 150 |   | 4,900 | + | 17,550  |
| (8) |               |                | (300)    |           |   |                    |             |              |                 |     |   |       |   | (300)   |
|     | 11,785        | +              | 1,115    | 400       | + | 9,000              | =           | 0            | +               | 150 |   | 4,900 | + | 17,250  |

(c)

| <b>TRAN'S CLOTHING ALTERATIONS</b>        |         |         |
|---|---------|---------|
| <b>Income Statement</b>                   |         |         |
| <b>for the month ended 31 August 2019</b> |         |         |
| <b>INCOME</b>                             |         |         |
| Services income                           |         | \$1 500 |
| <b>EXPENSES</b>                           |         |         |
| Rent expense                              | \$1 200 |         |
| Wages expense                             | 500     |         |
| Electricity expense                       | 250     |         |
| Supplies expense                          | 300     |         |
|   |         | 2 250   |
| <b>LOSS</b>                               |         | (\$750) |

| <b>TRAN'S CLOTHING ALTERATIONS</b>          |         |           |
|---|---------|-----------|
| <b>Statement of Cash Flows</b>              |         |           |
| <b>for the month ended 31 August 2019</b>   |         |           |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b> |         |           |
| Cash received from customers                | \$1 650 |           |
| Cash paid to suppliers and employees*       | (2 865) |           |
| Net cash used in operating activities       |         | \$(1 215) |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b> |         |           |
| Purchase of equipment                       | (5 000) |           |
| Net cash used in investing activities       |         | (5 000)   |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b> |         |           |
| Capital contribution from owner             | 18 000  |           |
| Net cash from financing activities          |         | 18 000    |
| Net increase in cash held                   |         | 11 785    |
| Cash at beginning of month                  |         | 0         |
| Cash at end of month                        |         | \$11 785  |

\* Cash paid to suppliers and employees = Rent \$1320 + Wages \$500 + Electricity \$275 + Accounts Payable \$770 = \$2865

| <b>TRAN'S CLOTHING ALTERATIONS</b>        |                 |
|---|-----------------|
| <b>Statement of Changes in Equity</b>     |                 |
| <b>for the month ended 31 August 2019</b> |                 |
| Tran, Capital – 1 August 2019             | \$ —            |
| Add: Capital contribution                 | 18 000          |
| Less: Loss for the month                  | (750)           |
| Tran, Capital – 31 August 2019            | <u>\$17 250</u> |

(d)

| <b>TRAN'S CLOTHING ALTERATIONS</b> |                  |                    |                  |
|------------------------------------|------------------|--------------------|------------------|
| <b>Balance Sheet</b>               |                  |                    |                  |
| <b>As at 31 August 2019</b>        |                  |                    |                  |
| <b>ASSETS</b>                      |                  | <b>LIABILITIES</b> |                  |
| Cash at bank                       | \$ 11 785        | Loan payable       | \$ \$4 900       |
| GST receivable                     | 1 115            | GST payable        | 150              |
| Supplies                           | 400              | <b>EQUITY</b>      |                  |
| Equipment                          | 9 000            | Tran, Capital      | 17 250           |
|                                    | <u>\$ 22 300</u> |                    | <u>\$ 22 300</u> |

**Problem 2.28**

**Correcting errors and preparing financial statements**

**Baker's Bread Shop was established on 1 April 2019 with an initial investment of \$100 000 by the owner. During the first few weeks of business, the owner employed a part-time accountant (with only a few months experience) who recorded the following list of assets.**

|                   |           |
|-------------------|-----------|
| Accounts payable  | \$ 37 100 |
| Buildings         | 100 000   |
| Cash at bank      | 31 000    |
| Furniture         | 12 000    |
| A. Baker, Capital | 150 000   |
| Baking supplies   | 5 600     |
| Loan payable      | 20 700    |

**The accountant also recorded the following list of liabilities and equity.**

|                           |           |
|---------------------------|-----------|
| Accounts receivable       | \$ 20 000 |
| Land                      | 43 200    |
| Mortgage payable          | 40 000    |
| Cash drawings by A. Baker | 36 000    |

**Required**

- (a) Assuming that the amounts above are correct, prepare a corrected balance sheet in narrative form.
- (b) Determine the amount of profit (loss) made by the business during the period of its first few weeks of existence, assuming that the owner had invested an additional \$20 000 into the business just before the amounts were calculated by the accountant.
- (c) Prepare a statement of changes in equity for the period.  
(LO3 and LO5)

(a)

| <b>BAKER'S BREAD SHOP</b>  |                  |
|----------------------------|------------------|
| <b>Balance Sheet</b>       |                  |
| <b>as at 30 April 2019</b> |                  |
| <b>ASSETS</b>              |                  |
| Cash at bank               | \$31 000         |
| Accounts receivable        | 20 000           |
| Baking supplies            | 5 600            |
| Land                       | 43 200           |
| Buildings                  | 100 000          |
| Furniture                  | 12 000           |
| <b>TOTAL ASSETS</b>        | <b>\$211 800</b> |
| <b>LIABILITIES</b>         |                  |
| Accounts payable           | 37 100           |
| Mortgage payable           | 40 000           |
| Loan payable               | 20 700           |
| <b>TOTAL LIABILITIES</b>   | <b>\$97 800</b>  |
| <b>NET ASSETS</b>          | <b>\$114 000</b> |
| <b>EQUITY</b>              |                  |
| A. Baker, Capital*         | 114 000          |
| <b>TOTAL EQUITY</b>        | <b>\$114 000</b> |

\* Capital contribution of \$150 000, less drawings of \$36 000.

(b) Ending capital = Beginning capital + Profit – Drawings + Additional capital contribution

$$\$114\,000 = \$100\,000 + X - \$36\,000 + \$20\,000$$

Solving for X: Profit = \$30 000

(c)

Profit calculation determined in the statement of changes in equity, as below.

| <b>BAKER'S BREAD SHOP</b>                    |                  |
|--|------------------|
| <b>Statement of Changes in Equity</b>        |                  |
| <b>for the few weeks ended 30 April 2019</b> |                  |
| A. Baker, Capital – 1 April 2019             | \$100 000        |
| Add: Additional capital contribution         | 20 000           |
| Profit for the period                        | 30 000           |
|  | <hr/>            |
|  | 150 000          |
| Less: Drawings during the period             | 36 000           |
|  | <hr/>            |
| A. Baker, Capital – 30 April 2019            | <u>\$114 000</u> |

## Problem 2.29

### Analysing financial statement elements

Jason Vu offers tutoring services to first-year university students. He has set up a sole proprietorship business named JV Tutoring. Jason has collected the following information relating to his business activities at the end of the financial year:

|                         |        |                     |        |
|-------------------------|--------|---------------------|--------|
| Office supplies         | \$1500 | Accounts payable    | \$1080 |
| Office supplies expense | 840    | Cash at bank        | 8445   |
| Telephone expense       | 255    | Computer equipment  | 8250   |
| Motor vehicle expense   | 330    | Advertising expense | 510    |
| Accounts receivable     | 1500   | Tutoring income     | 9750   |
| Bank loan               | 7500   |                     |        |

The following information was disclosed from examining Jason's bank statement:

|                               |        |                             |        |
|-------------------------------|--------|-----------------------------|--------|
| Tutoring receipts             | \$8250 | Payments to suppliers       | \$2355 |
| Initial contribution by James | 3300   | Repayment of loan           | 1500   |
| Bank loan received            | 9000   | Computer equipment purchase | 8250   |

### Required

- (a) Without preparing formal financial statements, calculate the following:
- profit/loss for the year
  - total assets at the end of the year
  - total liabilities at the end of the year
  - Jason Vu's capital balance at the end of the year
  - net cash inflow/outflow for the year.
- (b) Recalculate the figures you provided in requirement (a), assuming that Jason had withdrawn \$5000 in cash during the year.
- (c) Jason cannot deal with the demand for tutoring services. Simon, Jason's friend, is prepared to make a capital contribution and join the business as an owner. Advise Jason on the advantages and disadvantages of establishing the business as a partnership or company.
- (LO1, LO3 and LO5)

(a)

(i) Profit = Income – Expenses

- Total Income = Tutoring Income \$9750.
- Total Expenses = Office supplies expense \$840 + Telephone expense \$255 + Motor vehicle expense \$330 + Advertising expense \$510 = \$1935

**Profit = \$9750 – \$1935 = \$7815.**

(ii) Total Assets = Office supplies \$1500 + Accounts receivable \$1500 + Cash at bank \$8445 + Computer equipment \$8250 = \$19 695

**Total Assets = \$19 695.**

(iii) Total liabilities = Bank loan \$7500 + Accounts payable \$1080 = \$8580

**Total Liabilities = \$8580.**

(iv) Closing Capital = Opening capital \$3300 + Additional contributions \$0 + Profit \$7815 – Drawings \$0 = \$11 115

**Closing Capital = \$11 115.**

(v) Net Cash Inflow/(Outflow) = Cash flow from operations + Cash flow from investing activities + Cash flow from financing activities + Initial contribution

- Cash flow from operations = Tutoring receipts \$8250 – Payment to suppliers \$2355 = \$5895
- Cash flow from investing activities = Purchase of equipment (\$8250)
- Cash flow from financing activities = Bank loan received \$9000 – Bank loan repayment \$1500 = \$7500
- Net Cash Inflow/(Outflow) = Cash flow from operations \$5895 + Cash flow from investing activities (\$8250) + Cash flow from financing operations \$7500 + Initial contribution \$3300 = \$8445

**Net Cash Inflow/(Outflow) = \$8445.**

(b)

(i) No change.

$$\text{Profit} = \$9750 - \$1935 = \$7815.$$

(ii) Change.

Total Assets = Office supplies \$1500 + Accounts receivable \$1500 + Cash at bank \$3445 (i.e. \$8445 – \$5000) + Computer equipment \$8250 = \$14 695

$$\text{Total Assets} = \$14\ 695.$$

(iii) No change.

Total liabilities = Bank loan \$7500 + Accounts payable \$1080 = \$8580

$$\text{Total Liabilities} = \$8580$$

(iv) Change.

Closing capital = Opening capital \$3300 + Additional contributions \$0 + Profit \$7815 – Drawings \$5000 = \$6115

$$\text{Closing Capital} = \$6115.$$

(v) Change.

Net Cash Inflow/(Outflow) = Cash flow from operations + Cash flow from investing activities + Cash flow from financing activities + Initial contribution

- Cash flow from operations = Tutoring receipts \$8250 – Payments to suppliers \$2355 = \$5895.
- Cash flow from investing activities = Purchase of equipment (\$8250)
- Cash flow from financing activities = Bank loan received \$9000 – Bank loan repayment \$1500 – Drawings \$5000 = \$2500
- Net Cash Inflow/(Outflow) = Cash flow from operations \$5895 + Cash flow from investing activities (\$8250) + Cash flow from financing activities \$2500 + Initial contribution \$3300 = \$3445

$$\text{Net Cash Inflow/(Outflow)} = \$3445.$$

(c) By establishing a partnership, Jason has the advantage of having more resources through Simon's capital contributions. This additional capital can then be used to expand the tutoring business without the need to source a bank loan. Changing the business structure to a partnership also means that Jason can share the workload of managing the business with Simon, which will be helpful considering Jason is currently overloaded by the demand for tutoring services.

On the disadvantage side, Jason will need to share the business' profits with Simon in proportion to what is stipulated in the partnership agreement. A partnership, like sole proprietorship, has unlimited liability. As a partnership is not a separate legal entity, the individual partners (i.e. Jason and Simon) are personally liable for the partnership's debts. In addition, Jason as a partner will be liable for any action or decision that Simon makes on behalf of the partnership. This is called mutual agency.

If Jason decides to set up the tutoring business as a company, he will have all the advantages of a partnership as discussed above (i.e. additional capital and workload sharing), plus the benefit of limited liability. A company is a separate legal entity, which means that the owners (shareholders) are not personally liable for the debts of the company. Jason could also transfer/sell all or part of his shares in the company to Simon or someone else, had he wished not to continue with the tutoring business.

On the other hand, a company is more expensive to set up than a partnership. Financial and tax reporting requirements for companies are also far greater than the reporting requirements for partnership. Therefore, Jason needs to consider the costs and benefits of different business structures and make a decision accordingly.

## **Problem 2.30**

### **Preparation of financial statements**

**Yamindi was raised on a farm in the Northern Territory. While in high school, he was an active member of the local rural youth club and raised several prize animals that he sold at auction at state and local shows. He saved his earnings and by the time he finished secondary school, Yamindi had nearly \$5000 in a savings account. He was undecided whether to go on to tertiary education or use his savings in a business venture. Because of his love for animals, he believed he could successfully operate a pet warehouse store and decided to use the summer months as a trial.**

**During the month of October 2019, Yamindi located a small building that he could rent for \$100 per month. After transferring \$3000 from his savings account to a business bank account in the name of Pet Warehouse, he paid cash out of the account for rent and the purchase of supplies. Although he would not keep a full set of accounting records, he decided to deposit all receipts from sales into the bank account and to make all payments by direct debit out of the account. In this way he would have a relatively complete record of his business activities. Yamindi also kept a daily work book in which he recorded all sales to customers.**

**On 1 November, Yamindi opened his warehouse to the public. During the first 3 months, he was unusually busy. Early in February he needed to make a decision on continuing the operation of the business or to enrol for the first semester at university. To help him make this important decision, Yamindi reviewed his bank account and daily sales book to determine how well he had done. The review disclosed the following:**

- 1. Total cash deposited in the account (including the initial \$3000 deposit) was \$8920.**
- 2. The daily work book showed that on 31 January customers owed him \$1000 for goods supplied, which he expected to collect during February.**
- 3. Direct debits had been made out of the account for:**
  - Rent payments, \$400 for the months of November to February.**
  - The purchase of grooming equipment, \$4500. The equipment cost \$5000 and Yamindi still owed the supplier \$500 on the purchase.**
  - Grooming supplies, \$560. Yamindi estimated that the cost of grooming supplies on hand at 31 January was \$160.**
  - The payment of electricity bills for the months of November and December, \$600. He had just received his bill for the month of January for the amount of \$350, but had not yet paid it.**
  - Advertising paid, \$1216.**
  - Withdrawals made by Yamindi to pay for personal expenses, \$1300.**

### **Required**

- (a) Prepare an income statement for Yamindi's Pet Warehouse for the 3-month period from 1 November 2019 to 31 January 2020.**
- (b) Prepare a balance sheet as at 31 January 2020 and a statement of changes in equity for the 3-month period.**

(c) What other information would you need to determine how well Yamindi had done during the 3-month period?  
(LO3, LO4 and LO5)

(a)

| <b>YAMINDI'S PET WAREHOUSE</b>                    |                |
|---|----------------|
| <b>Income Statement</b>                           |                |
| <b>for the three months ended 31 January 2020</b> |                |
| <b>INCOME</b>                                     |                |
| Sales revenue [ $\$8920 - \$3000 + 1000$ ]        | \$6 920        |
| <b>EXPENSES</b>                                   |                |
| Electricity expense [ $\$600 + \$350$ ]           | \$950          |
| Rent expense [ $3 \text{ months} \times \$100$ ]  | 300            |
| Advertising expense                               | 1 216          |
| Supplies expense [ $\$560 - \$160$ ]              | 400            |
|   | <u>2 866</u>   |
| <b>PROFIT</b>                                     | <u>\$4 054</u> |

(b)

| <b>YAMINDI'S PET WAREHOUSE</b>                    |                |
|---|----------------|
| <b>Statement of Changes in Equity</b>             |                |
| <b>for the three months ended 31 January 2020</b> |                |
| Yamindi, Capital – 1 November 2019                | \$3 000        |
| Add: Profit for the three months                  | 4 054          |
|   | <u>7 054</u>   |
| Less: Drawings during the month                   | 1 300          |
| Yamindi, Capital – 31 January 2020                | <u>\$5 754</u> |

| <b>YAMINDI'S PET WAREHOUSE</b> |                       |                     |                       |
|--------------------------------|-----------------------|---------------------|-----------------------|
| <b>Balance Sheet</b>           |                       |                     |                       |
| <b>as at 31 January 2020</b>   |                       |                     |                       |
| <b>ASSETS</b>                  |                       | <b>LIABILITIES</b>  |                       |
| Cash at bank                   | \$ 344                | Accounts payable    | \$ 500                |
| Accounts receivable            | 1 000                 | Electricity payable | 350                   |
| Prepaid rent                   | 100                   | Total liabilities   | <u>850</u>            |
| Grooming supplies              | 160                   | <b>EQUITY</b>       |                       |
| Grooming equipment             | <u>5 000</u>          | Yamindi, Capital    | <u>5 754</u>          |
|                                | <b><u>\$6 604</u></b> |                     | <b><u>\$6 604</u></b> |

(c) Several additional items would be useful to determine how well Yamindi had done in the 3-month period:

1. The useful life of the grooming equipment so that an expense could be determined for depreciation.
2. The amount of interest that Yamindi could have earned on the \$3000 if he had invested it in an alternative manner.
3. The amount Yamindi could have earned during the 3-month period if a job were available.
4. The current value of the assets of the business as a whole on 31 January 2020.

## Case studies

### Decision analysis

#### Schutz Building Services financial statements

Schutz Building Services is a fast-growing business in the housing industry. Johan Schutz started the business 3 years ago and has worked hard to establish the firm. Johan has no accounting knowledge and simply keeps his invoices and receipts in a shoebox that he takes to his accountant once a year to be sorted out and turned into financial statements for tax purposes. Johan does not use the financial statements for decision making. So long as he has cash in the bank, Johan is satisfied with how his business is operating. Unfortunately, Johan's accountant has suddenly left the country and retired to South America.

Johan is negotiating a contract with a supplier of building materials who wants to see his financial statements to ensure that Johan can meet his payments each month. Johan has asked you to prepare financial statements. Based on his last tax return and the contents of his shoebox for this year, you have established the following items.

|  |         |
|--|---------|
| Cash in the shoebox (with the receipts and invoices) | \$ 500  |
| Cash in the bank account                             | 3 800   |
| Building services provided                           | 550 000 |
| Amounts owed by customers                            | 80 000  |
| Wages paid to employees                              | 150 000 |
| Wages owed to the employees                          | 3 500   |
| Equipment  | 68 000  |
| Building supplies used                               | 310 000 |
| Building supplies on hand                            | 18 000  |
| Amounts owed to suppliers                            | 30 000  |
| Motor vehicle  | 32 000  |
| Motor vehicle expenses                               | 5 600   |
| Electricity and telephone expense                    | 4 000   |
| Cash used by Johan for personal expenditure          | 5 700   |

#### Required

- (a) Using the information, provide an income statement and a balance sheet in narrative form for Schutz Building Services for the current period.
- (b) How would the financial statements you produce help the supplier of building materials decide whether or not to trade with Johan? What parts of the financial statements would be positive indicators that Schutz Building Services would pay for supplies on time and what items may cause some concern for the supplier?

(a)

| <b>SCHUTZ BUILDING SERVICES</b>         |           |                 |
|---|-----------|-----------------|
| <b>Income Statement</b>                 |           |                 |
| <b>For the year ended 30 June .....</b> |           |                 |
| <b>INCOME</b>                           |           |                 |
| Service revenue                         |           | \$550 000       |
| <b>EXPENSES</b>                         |           |                 |
| Wages expense                           | \$153 500 |                 |
| Supplies expense                        | 310 000   |                 |
| Motor vehicle expense                   | 5 600     |                 |
| Electricity and telephone expense       | 4 000     |                 |
|   | 473 100   |                 |
| <b>PROFIT</b>                           |           | <b>\$76 900</b> |

| <b>SCHUTZ BUILDING SERVICES</b> |  |                  |
|---------------------------------|--|------------------|
| <b>Balance Sheet</b>            |  |                  |
| <b>as at 30 June</b>            |  |                  |
| <b>ASSETS</b>                   |  |                  |
| Cash on hand                    |  | \$500            |
| Cash at bank                    |  | 3 800            |
| Accounts Receivable             |  | 80 000           |
| Supplies                        |  | 18 000           |
| Motor vehicle                   |  | 32 000           |
| Equipment                       |  | 68 000           |
| <b>TOTAL ASSETS</b>             |  | <b>\$202 300</b> |
| <b>LIABILITIES</b>              |  |                  |
| Accounts payable                |  | 30 000           |
| Wages payable                   |  | 3 500            |
| <b>TOTAL LIABILITIES</b>        |  | <b>\$33 500</b>  |
| <b>NET ASSETS</b>               |  | <b>\$168 800</b> |
| <b>EQUITY</b>                   |  |                  |
| J. Schutz, Capital              |  | \$168 800        |
| <b>EQUITY</b>                   |  | <b>\$168 800</b> |

(b) The total equity of \$168 800 compared to total liabilities of \$33 500 is a good indication of the net position of the business, i.e.  $\text{Net assets} = \text{Total assets} - \text{Total liabilities} = \$168\,800$ . Current assets of \$102 300 well exceed the liabilities of \$33 500. The only real concern could be with the level of accounts receivable that may suggest that Johan is not very diligent about collecting amounts from his customers.

The supplier would need more information on the entity's ability to pay for materials in addition to the total net assets.

A statement of cash flows would provide details on cash flows from operations, cash flows from investing activities and cash flows from financing activities. This would assist the supplier in assessing the firm's ability to pay for materials.

## **Critical thinking**

### **Intangibles Reporting**

**Read the following the article ‘Intangibles reporting’ and answer the question below.**

#### **Required**

- (a) Using this framework discuss whether brand names are ‘valuable assets’ of a business, or an expense.**
- (b) Use the definitions of assets and expenses in this book to show which of the elements of the financial statements ‘brand names’ should be classified under.**

(a) and (b) Brand names can be built in house or purchased as a result of acquiring a business with a well-known brand name. Assets are defined as resources controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity. Brand names (for example, Samsung) could certainly be said to provide future economic benefits through the future sales obtained by the organisation as a result of having such as well-known and regarded product. The creation of the brand would also constitute a valid past event (in the event of the brand being built in house) as would the purchase of a brand in the event of business buying another. The business would also ‘control’ the brand. The business can invest in the brand, promote the brand and protect the brand. The question with a brand name is whether it can be reliably valued. In the event of a brand name being purchased as a result of acquiring a business (or brand) there is a transaction with an external party that involves a transaction price for the brand. The valuation of a brand in the absence of a brand or business acquisition is more subjective. While there are accepted means to value brand names, the accounting rules only allow brands to be assets and appear on the balance sheet if they have been acquired. Brand names that have been internally generated are not permitted to be recognised as an asset on the balance sheet. Hence any costs incurred in building a brand internally are expensed. The costs represent decreases in economic benefits in the form of an outflow or depletion of assets or the incurrence of liabilities in the form of reductions in assets or increases in liabilities.

## Communication and leadership

### Performance of accounting firms

The ownership structure of professional service firms, such as accounting firms, can vary. In an exploratory study, Pickering (2012) compares the performance of accounting firms with different ownership structures. In groups of three or four, consider the following issues related to Pickering (2012).

#### Required

- (a) Discuss the different forms of ownership a professional service firm can take.
- (b) Articulate the research question that Pickering (2012) is trying to address.
- (c) Explain the research design used by Pickering (2012) to address the research question.
- (d) Summarise the findings of Pickering (2012).

*Source: Pickering, M. (2012), Accounting Firms: Exploring Relative Performance, Performance Measurement and Measurement Issues, Australasian Accounting Business and Finance Journal, Volume 6, Issue 3.*

- (a) Different forms of ownership a Professional Service Firm (PSF) can take include:
- **Partnership:** this is the traditional structure of a PSF. In a partnership, partners are the owners, managers and key professionals providing services to clients. Each partner is personally liable for the partnership's debts and actions taken by other partners (i.e. unlimited liability). Partnership is the most common business structure for PSFs as it is viewed as the most optimal form for managing professionals by balancing the conflicting needs of owners, professionals and clients.
  - **Limited liability partnership:** this structure was introduced in response to large legal settlements paid by partnerships, which then became partners' personal liabilities. Limited liability partnerships are similar to traditional partnerships, except that partners in a limited liability partnership has limited personal liability over the partnership's debts.
  - **Private corporation:** a private corporation is a company owned by relatively small shareholders, which do not trade the company's shares to public through the market. Rather, the company's shares are traded or exchanged privately.
  - **Publicly listed company (PLC):** in the late 1990s, a trend has emerged in which PSFs (mainly accounting firms) moved from traditional partnership structure to PLC. The trend began when thousands of smaller accounting firms were acquired by companies such as American Express and H&R Block. The move towards public ownership for PSFs may be caused by various factors such as growth in size, increasing complexity of partnership, increasing risk of litigation, and growing need for capital.

(b) In his article, Pickering is addressing four research questions that explore:

1. How does the performance of partnerships compare with that of publicly listed accounting firms?

Some past studies about performance of different forms of ownership of large consulting firms and advertising firms suggest that publicly listed company is a less efficient form of ownership for PSFs compared to partnership. However, there is limited research in investigating why PSFs are moving into less efficient ownership form, mainly due to inconsistent proxy measures of performance.

2. Do proxy measures of performance reflect the underlying performance of accounting firms?

In comparing performance between different ownership forms, prior studies commonly used proxies of performance (mainly revenue) sourced from industry publications' ranking reports as private firms (including partnerships) do not usually release their financial results to public. The question arises of whether the proxies used reflect the underlying performance for different ownership forms, as different ownership form may have different cost structure and this may be overlooked in calculating the proxies.

3. Do budgeted revenue numbers reported in the published industry surveys reflect actual revenues achieved?

Revenue is the main proxy used in comparative analysis between different ownership forms. As mentioned above, it is common for researchers to use revenue figures from published industry surveys to do the analysis. Since there might be different ways in reporting what is included in a firm's revenue, Pickering's study attempts to explore the quality of published industry survey data to determine if the revenue published by industry survey is consistent with the actual revenue earned.

4. Are consistent measures and calculations of measures used across the period of BRW Top 100 surveys?

There might be errors and inconsistencies in the published industry data, such as BRW surveys. Industry surveys may not report the methods used in calculating data, and therefore care is required in using industry survey data and in making sure that the methods used in calculating the data is consistent throughout periods.

(c) To compare performance across ownership form (i.e. between partnerships and publicly listed accounting firms), Pickering used to proxy measures, namely revenue growth and revenue per person (including partners and all staff), which is a productivity related measure. Revenue per person is calculated by dividing annual revenues by reported year-end number of staff. The revenue growth (from year 1999 to 2005) and revenue per person (from year 2000 to 2005) of two Australian publicly listed accounting companies (i.e. WHK Group and Stockford Limited) and 10 mid-tier partnerships were then compared.

In exploring the validity of proxy measures (i.e. whether proxy measures of performance reflect the underlying performance of accounting firms), Pickering compared performance of the two publicly listed accounting firms (as discussed above) as measured by publicly available proxy measures (i.e. revenue growth and revenue per person) to the underlying performance from the firms' financial reports for the year ended 30 June 2002. He also reviewed reported revenue per person per BRW surveys for firms with extremely high or low revenue per person and investigated reasons by reviewing various published media reports. In investigating the validity of productivity measure (i.e. revenue per person), Pickering recalculated revenue per person measure using average number of staff for the year and compare it to the revenue per person calculated using number of staff at the end of the year, which is usually used in BRW magazine surveys.

To explore the quality of published industry survey data, Pickering compared published BRW survey data for the two publicly listed companies to information published in their annual reports. Pickering also compared budgeted revenue numbers for each of the 10 partnership sample firms in the BRW survey to the prior year actual revenues reported in the following year's BRW survey (for the period 1999 to 2005).

In examining the consistency of measures and calculation of measures used in published industry survey data, Pickering examined survey headings in BRW accounting survey from 1999 to 2005 and recalculated BRW reported revenues per professional and per person based on survey reported revenues and resource numbers.

(d) The findings of Pickering's study are as follows:

- Revenue growth of publicly listed accounting firms significantly exceed the revenue growth of mid-tier partnerships. However, when performance is measured as revenue per person, the accounting partnerships outperformed publicly listed accounting firms. Revenue per person for publicly listed accounting firms is lower than the average revenue per person for the sample of 10 accounting partnerships and, in most cases, lower than each of the firms in the sample for the period studied.
- Discrepancies between revenue figures published in BRW surveys and those reported in the annual report of publicly listed accounting firms. Discrepancies are also found between the number of staff in publicly listed accounting firms as reported in BRW survey and in the annual report. In regards to measuring productivity, it was found that BRW surveys used end of year staff numbers in calculating revenue per person, which causes understatement of PLC productivity compared to partnerships.
- Nine observations were identified where actual partnership revenues for the prior year differed by + or – 10% from budgeted revenues reported in the prior year BRW survey. The differences were found to be due to the treatment of revenues from mergers and demergers, with partnerships backdating the transaction to the start of the period (or even the period before) and PLCs recording revenues from the date of the transaction.
- Inconsistencies were found in the measures used in BRW surveys. For example, in year 1999 to 2004 the surveys report number of professionals and revenue per professional, but then use number of accountants and revenue per accountant in 2005.

## Ethics and governance

Read the article ‘BHP Billiton hit with \$US25m fine over corruption allegations’ and answer the questions.

### Required

- (a) Identify the stakeholders in this situation.
- (b) Determine the ethical issues (if any) involved.
- (c) Comment on the ethics of bribing officials in a country where you are conducting business given that such actions are part of the country’s normal business practice, but they are unacceptable in your own country.
- (d) In other articles discussing these activities, reference has been made to a Global Witness report. Provide a dossier on Global Witness (see [www.globalwitness.org/](http://www.globalwitness.org/)).
- (e) Locate the charter of BHP’s Risk and Audit Committee. Summarise the role of this committee.

(a) The stakeholders in this situation are:

- BHP executives who were involved in inviting executives to the Games.
- BHP board and senior executives.
- BHP staff and shareholders.
- US Securities and Exchange Commission.
- US Department of Justice.
- Invited officials.
- Australian Federal Police.
- BHP Auditors.
- Australian Securities and Investments Commission.
- Olympic Games.
- Global regulators.

(b) The ethical issues involved are:

- BHP executives provided Olympic Games’ hospitality packages to government officials in countries where they had/wanted mining interests. BHP invited 176 government officials to attend the Olympics at the company’s expense with many of the invited guests being associated with customers or suppliers of BHP.
- The actions were initiated under the Foreign Corrupt Practices Act and violating anti-corruption laws.

(c) The answer to this will depend on the student’s own ethical stance. In Australia it is illegal to bribe someone either in Australia or when an Australian company does business in another country. If an Australian or Australian company is caught bribing anywhere in the world then they may be liable for prosecution under Australian laws.

A contrary view is that if bribery is part of a country’s normal business practice, we do not have the right to impose our belief on another country, especially when we do business in that country. Although bribery maybe considered unethical and unacceptable in our own country, it may be just part of another country’s culture which has been implanted for generations and becomes a normal practice. In countries where bribery is seen as a normal business practice, it may be necessary to bribe the

other party involved, otherwise works will not get done and there will be delays which could cause negative impacts for all involved.

(d) Established in 1993, Global Witness is a British-based non-government organisation which investigates and campaigns to prevent natural resource-related conflict and corruption and associated environmental and human rights abuses. Global Witness believes that abundant natural resources can provide incentives for corruption, destabilise government, and lead to war. Hence, the organisation aims to expose brutality and injustice that results from the fight to access and control natural resource wealth, as well as seeking solutions that could benefit citizens of resource-rich countries in sharing their countries' wealth.

Global Witness' works fall into four broad strands:

- **Corruption:** Global Witness campaigns against companies and governments who facilitate corruption and divert money from natural resources away from the citizens;
- **Conflict:** Global Witness campaigns to prevent the continuation of armed conflict and human right abuses resulting from fighting over natural resources;
- **Environmental governance:** Global Witness campaigns against destruction and over-exploitation of forests and land;
- **Maximising accountability and transparency:** Global Witness is working to bring transparency in commercial deals in natural resource sector so that citizens in resource-rich countries can hold government and businesses accountable in managing the resources.

(e) The role of BHP's Risk and Audit Committee (as per the terms of reference document) is:

1. The role of the Risk and Audit Committee (Committee) is to support and advise the Boards of BHP Billiton Limited and BHP Billiton Plc (Board) in relation to the matters set out in these Terms of Reference. The Committee is accountable to the Board for its performance.
2. The Committee's responsibilities are set out in these Terms of Reference and include assisting the Board in overseeing the integrity of the Group's financial statements and Annual Report, the effectiveness of internal and external audit processes, the Group's systems of internal control and risk management, the Group's systems for compliance with relevant legal and regulatory requirements within the Committee's area of responsibility and the Group's capital structure and funding.
3. The Committee acts primarily as an advisory body to the Board. In making recommendations to the Board, the Committee does not, of itself, have the power or authority of the Board in dealing with the matters on which it advises, except where certain powers are specifically set out in these Terms of Reference or are otherwise delegated by the Board.

The Terms of Reference, at the time of writing, are available

at: [http://www.bhpbilliton.com/-media/documents/ourapproach/governance/160707\\_riskandauditcommittee.pdf?la=en](http://www.bhpbilliton.com/-media/documents/ourapproach/governance/160707_riskandauditcommittee.pdf?la=en)

In relation to this question, having a hospitality program for government officials is likely to be considered inappropriate. Government officials usually have code of conducts whereby they should not accept hospitality offers or gifts with value exceeding certain amount. Of course it depends on the nature of the hospitality program being offered (e.g. a once-off modest dinner may be appropriate), however the hospitality program that BHP offered was questioned in relation to it being a bribe due to its nature and surrounding circumstances.

## **Financial analysis**

### **Apple Inc.**

**Refer to the latest financial report of Apple on its website, <http://investor.apple.com>. Answer the following questions using the consolidated balance sheet and notes to the consolidated financial statements.**

#### **Required**

- (a) State the accounting equation for Apple in dollar figures at the end of the reporting period for the end and beginning of the last reporting year. Comment on what this reveals about Apple's financing policy.**
- (b) Explain why the change in total assets equals the change in total liabilities plus the change in total equity.**
- (c) State Apple's profit (loss) for the last reporting year.**
- (d) Determine Apple's net increase (decrease) in cash flows for the last reporting period in aggregate and by operating, investing and financing categories.**
- (e) Explain how Apple could apply the principle of materiality of an item of financial information when preparing financial reports.**
- (f) In the business case at the start of this chapter, Apple is identified as a company that ranks highly on the Global Reputation Index. Research and report on the factors that contribute to Apple's high ranking in this index.**
- (g) Corporate reporting is evolving and is more than reporting on profits. Reporting on the entity's performance related to people and the planet is increasingly important and included within the annual report or as a stand-alone report. List examples of such reporting by Apple.**

**The solution below is based on the Apple Inc. Annual Report for the year ending 29 September 2016, available on Apple's website: <http://investors.apple.com>.**

(a) Accounting equation for Apple as at 24 September 2016 (in \$millions):

$$\begin{aligned}\text{Assets} &= \text{Liabilities} + \text{Equity} \\ \$321\,686 &= \$193\,437 + \$128\,249\end{aligned}$$

Accounting equation for Apple as at 26 September 2015 (in \$millions):

$$\begin{aligned}\text{Assets} &= \text{Liabilities} + \text{Equity} \\ \$290\,345 &+ \$170\,990 + \$119\,355\end{aligned}$$

The accounting equation reflects an entity's financing policy. That is, an entity's assets can be funded by either creditors (i.e. liabilities) or owners (i.e. equity). Looking at the accounting equation for Apple as at the end of September 2016, it can be seen that a larger proportion of Apple's assets is funded by liabilities than by the owners (shareholders).

At the end of September 2015, the debt to assets ratio, calculated as total liabilities divided by total assets, is 59 percent. This shows that 59 percent of Apple's assets in the beginning of the period is funded by creditors through borrowings and the remaining 41 percent is funded by shareholders through equity.

At the end of September 2016, the debt to assets ratio has remained at a similar level being 60%.

(b) The \$31 341 million increase in Apple's total assets (i.e. \$321 686 million less \$290 345 million) less the \$22 447 million increase in Apple's total liabilities (i.e. \$193 437 million less \$170 990 million) equals the \$8894 million change in total equity calculated as \$128 249 million less \$119 355 million. This must be so because of the accounting equation. We are effectively taking the difference in the financial position of the entity at two points in time, expressed in terms of either the net assets (Total Assets less Total Liabilities), or the equity of the entity.

(c) Apple's profit (referred to as 'net income' in the Consolidated Statement of Operations on p.39 of the annual report) for the period ending 24 September 2016 amounted to \$45 687 million, or over \$45 billion.

(d) Information about Apple's cash flows can be found in the Consolidated Statement of Cash Flows on p.43 of the annual report.

Apple's net decrease in cash flows for the year ending 24 September 2016 was \$636 million. This can be disaggregated into:

- \$65 824 million cash generated by operating activities. The largest cash flows under operating activities were contributed by customers through sales income.
- \$45 977 cash used in investing activities, with largest cash inflows and outflows from purchase and sale of marketable securities.
- \$20 483 cash used in financing activities, mainly from payments of dividends to shareholders and share repurchases.

(e) The concept of materiality relates to the significance of financial information in the financial report. Information is material if the omission or misstatement of that particular information will influence users in making economic decisions. The application of materiality differs between entities, as what is considered material for one entity might be considered immaterial for another entity. Thus, assessing which information is material requires considerable professional judgment.

In applying the principle of materiality of financial information in its financial statements, Apple needs to consider which information is relevant to users in the context of economic decision-making. Although the assessment of what is material entirely depends on each entity and there is no accounting standard that provides quantitative guidelines to determine materiality, Apple could use some common rules in assessing materiality such as:

- nature of the information (for example, information about Apple's plan to discontinue one of its major products is material by nature in understanding the company's scope of operations);
- percentage of profit before tax (e.g. an omission or error greater than five percent of profit is more likely to be considered as material);
- percentage of total assets;
- percentage of total revenue;
- percentage of equity.

(f) According to the 2015 Global Corporate Reputation Index, Apple is included in the top 25 companies with the strongest corporate reputations in the index.

Information on The Global Corporate Reputation Index is available at:

<https://www.reputationinstitute.com/thought-leadership/global-reprak-100>

The Global Reputation Index measures the reputation of nearly 6,000 companies in six countries based on 40,000 consumer interviews regarding company qualities. The two sets of attributes identified in the index that drives corporate reputation are performance (i.e. perceived success of a company's products or services) and citizenship (i.e. a company's works in being a good corporate citizen such as adoption of environmentally friendly policies or sponsorship of charity organisations and community events).

Some factors that might contribute to Apple's high ranking in this index include:

- The company's financial success in generating profit of more than \$45 billion.
- Worker's empowerment program that helps workers in learning about Code of Conducts, their rights as workers, occupational health and safety, etc.
- Apple's Supplier Employee Education and Development program that offers workers to take free classes on a range of subjects, such as finance, computer, and English.
- Worker protection against discrimination on the basis of race, color, age, gender, sexual orientation, ethnicity, disability, religion, political affiliation, union membership, national origin, and marital status, and prohibits pregnancy tests or medical tests for discriminatory use.
- Zero-tolerance policy on underage labour.
- Prevention of excessive work hours.

- Requirements for Apple's suppliers to provide a safe work environment, to eliminate physical hazards wherever possible, and to establish administrative controls that reduce risk.
- Requirements for Apple's facilities to hold up-to-date permits for air emissions, wastewater discharge, hazardous waste disposal, X-ray equipment, and boundary noise.
- Strict policies on ethical conducts when dealing with workers, suppliers and customers, with violations of these conducts resulting in immediate termination with suppliers.

*Source: Apple Supplier Responsibility Progress Report.*

(g) Examples of sustainability reporting by Apple:

- 93 percent of its energy came from renewable sources.
- 99 percent of the paper in its packaging is recycled or sustainable.
- Apple Renew — a program that allows recycling any Apple device at an Apple Store.
- Full Material Disclosure program that shows us the chemical composition of every material in every component of our products.
- Empowering workers through training and free educational development program.
- Commitment to end excessive working hours, prohibit unethical hiring policies, and prevent the hiring of underage workers.
- Working with suppliers to make working conditions safer (e.g. suppliers must provide protective gears and other safety equipment for workers) and to improve worker's well-being (e.g. by conducting extensive research to identify opportunities for improvement in areas such as social support networks, quality of sleep, dining facilities, and counselling services).
- Vigorous enforcement of suppliers' Code of Conduct that requires suppliers to provide safe and healthy working conditions, to use fair hiring practices, to treat their workers with dignity and respect, and to adhere to environmentally responsible practices in manufacturing.

See <http://www.apple.com/environment/>.